

# Internal Revenue bulletin

Bulletin No. 1999-36  
September 7, 1999

## HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

### INCOME TAX

#### **Rev. Rul. 99-37, page 336.**

**Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate.** For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 1999.

#### **Rev. Rul. 99-38, page 335.**

**Low-income housing credit; satisfactory bond; "bond factor" amounts for the period July through September 1999.** This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period July through September 1999.

#### **T.D. 8833, page 338.**

Final regulations under section 1502 of the Code relate to the treatment of overall foreign losses and separate limitation losses in the computation of the foreign tax credit limitation.

#### **REG-116733-98, page 392.**

Proposed regulations under section 355(e) of the Code relate to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. A public hearing is scheduled for January 26, 2000.

#### **Notice 99-43, page 344.**

This notice announces a modification of the current rules under section 897 of the Code regarding transfers, exchanges, and other dispositions of U.S. real property interests in nonrecognition transactions under section 368(a)(1)(E) or 368(a)(1)(F) of the Code occurring after June 18, 1980.

### EXEMPT ORGANIZATIONS

#### **REG-121946-98, page 403.**

Proposed amendments to the regulations relate to the public disclosure requirements described in section 6104(d) of the Code.

Finding Lists begin on page ii.

Index for July and August begins on page iv.

#### **Notice 99-47, page 391.**

This notice provides guidance concerning a competent authority agreement between the United States and Canada that implements Article XXI (Exempt Organizations) of the United States-Canada Tax Convention (Treaty).

#### **Announcement 99-88, page 407.**

A list is given of organizations now classified as private foundations.

### ADMINISTRATIVE

#### **REG-107069-97, page 346.**

Proposed regulations under sections 338 and 1060 of the Code relate to the allocation of purchase price to determine the amount realized and the amount of basis allocated to each asset transferred in deemed and actual asset acquisitions. A public hearing is scheduled for October 12, 1999.

#### **Notice 99-47, page 391.**

This notice provides guidance concerning a competent authority agreement between the United States and Canada that implements Article XXI (Exempt Organizations) of the United States-Canada Tax Convention (Treaty).

#### **Announcement 99-89, page 408.**

This document contains corrections to Rev. Rul. 99-23, 1999-20 I.R.B. 3, dated May 17, 1999, relating to start-up expenditures under section 195 of the Code.

#### **Announcement 99-90, page 409.**

Form 10318, Deduction for Depletion on Ground Water Used for Irrigation, is obsolete.

#### **Announcement 99-93, page 409.**

This announcement corrects an error in the instructions for Form 8853, Medical Savings Accounts and Long-Term Care Insurance Contracts, and Form 5329, Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs, regarding when to report earnings on certain excess contributions withdrawn from medical savings accounts.



Department of the Treasury  
Internal Revenue Service

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities

and by applying the tax law with integrity and fairness to all.

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and proce-

dures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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# Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

## Section 42.—Low-Income Housing Credit

**Low-income housing credit; satisfactory bond; “bond factor” amounts for the period July through September 1999.** This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period July through September 1999.

## Rev. Rul. 99-38

In Rev. Rul. 90-60, 1990-2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that

the Secretary would publish in the Internal Revenue Bulletin a table of “bond factor” amounts for dispositions occurring during each calendar month.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) for dispositions of qualified low-income buildings or interests therein during the period July through September 1999.

Table 1  
Rev. Rul. 99-38  
Monthly Bond Factor Amounts for Dispositions Expressed  
As a Percentage of Total Credits

Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year													
Month of Disposition	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Jul '99	45.71	60.18	75.06	76.18	79.16	82.50	85.93	89.30	92.70	96.38	100.22	104.36	107.43
Aug '99	45.71	60.18	75.06	75.97	78.94	82.27	85.69	89.04	92.44	96.11	99.95	104.10	107.43
Sep '99	45.71	60.18	75.06	75.77	78.73	82.05	85.45	88.80	92.19	95.85	99.69	103.86	107.43

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see the following revenue rulings: Rev. Rul. 98-3, 1998-2 I.R.B. 4, for dispositions occurring during the calendar years 1996 and 1997; Rev. Rul. 98-13, 1998-11 I.R.B. 4, for dispositions occurring during the period January through March 1998; Rev. Rul. 98-31, 1998-25 I.R.B. 4, for dispositions occurring during the period April through June 1998; Rev. Rul. 98-45, 1998-38 I.R.B. 4, for dispositions occurring during the period July through September 1998; Rev. Rul. 99-1, 1999-2 I.R.B. 4, for dispositions occurring during the period October through December 1998; Rev. Rul. 99-18, 1999-14 I.R.B. 3, for dispositions occurring during the period January through March 1999; and Rev. Rul. 99-24, 1999-21 I.R.B. 3, for dispositions occurring during the period April through June 1999.

## DRAFTING INFORMATION

The principal author of this revenue

ruling is Gregory N. Doran of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Doran on (202) 622-3040 (not a toll-free call).

## Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, page 336.

## Section 354.—Exchange of Stock

*26 CFR 1.354-1: Exchange of stock and securities in certain reorganizations.*

To what extent are I.R.C. section 354 exchanges of stock of U.S. real property holding corporations in reorganizations described in I.R.C. section 368(a)(1)(E) or (F) taxable under Temp. Reg. section 1.897-6T(a)(1)? See Notice 99-43, page 344.

## Section 368(a)(1)(E) or (F).—Corporate Reorganizations

*26 CFR 1.368-2: Definitions relating to corporate reorganizations.*

To what extent are I.R.C. section 354 exchanges of stock of U.S. real property holding corporations in reorganizations described in I.R.C. section 368(a)(1)(E) or (F) taxable under Temp. Reg. section 1.897-6T(a)(1)? See Notice 99-43, page 344.

## Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of September 1999. See Rev. Rul. 99-37, page 336.

## Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month

of September 1999. See Rev. Rul. 99-37, on this page.

### Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, on this page.

### Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, on this page.

### Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, on this page.

### Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month

of September 1999. See Rev. Rul. 99-37, on this page.

### Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, on this page.

### Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, on this page.

### Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, on this page.

### Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

**Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate.** For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 1999.

### Rev. Rul. 99-37

This revenue ruling provides various prescribed rates for federal income tax purposes for September 1999 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 99-37 TABLE 1  
Applicable Federal Rates (AFR) for September 1999

*Period for Compounding*

	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
<i>Short-Term</i>				
AFR	5.42%	5.35%	5.31%	5.29%
110% AFR	5.98%	5.89%	5.85%	5.82%
120% AFR	6.52%	6.42%	6.37%	6.34%
130% AFR	7.08%	6.96%	6.90%	6.86%
<i>Mid-Term</i>				
AFR	5.98%	5.89%	5.85%	5.82%
110% AFR	6.58%	6.48%	6.43%	6.39%
120% AFR	7.19%	7.07%	7.01%	6.97%
130% AFR	7.81%	7.66%	7.59%	7.54%

REV. RUL. 99-37 TABLE 1—Continued  
Applicable Federal Rates (AFR) for September 1999

	<i>Period for Compounding</i>			
	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
<i>Mid-Term—Continued</i>				
150% AFR	9.04%	8.84%	8.74%	8.68%
175% AFR	10.58%	10.31%	10.18%	10.10%
<i>Long-Term</i>				
AFR	6.25%	6.16%	6.11%	6.08%
110% AFR	6.89%	6.78%	6.72%	6.69%
120% AFR	7.53%	7.39%	7.32%	7.28%
130% AFR	8.17%	8.01%	7.93%	7.88%

REV. RUL. 99-37 TABLE 2  
Adjusted AFR for September 1999

	<i>Period for Compounding</i>			
	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
Short-term adjusted AFR	3.77%	3.74%	3.72%	3.71%
Mid-term adjusted AFR	4.49%	4.44%	4.42%	4.40%
Long-term adjusted AFR	5.26%	5.19%	5.16%	5.13%

REV. RUL. 99-37 TABLE 3  
Rates Under Section 382 for September 1999

Adjusted federal long-term rate for the current month	5.26%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.26%

REV. RUL. 99-37 TABLE 4  
Appropriate Percentages Under Section 42(b)(2) for September 1999

Appropriate percentage for the 70% present value low-income housing credit	8.43%
Appropriate percentage for the 30% present value low-income housing credit	3.61%

REV. RUL. 99-37 TABLE 5  
Rate Under Section 7520 for September 1999

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	7.2%
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## Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99–37, page 336.

## Section 1502.—Regulations

26 CFR 1.1502–9: Consolidated overall foreign losses and separate limitation losses.

### T.D. 8833

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

### Consolidated Returns— Consolidated Overall Foreign Losses and Separate Limitation Losses

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final consolidated return regulations relating to the treatment of overall foreign losses and separate limitation losses in the computation of the foreign tax credit limitation. The regulations replace existing guidance with respect to overall foreign losses and provide guidance with respect to separate limitation losses. These regulations affect consolidated groups that compute the foreign tax credit limitation or that dispose of property used in a foreign trade or business.

DATES: *Effective Date:* These regulations are effective August 11, 1999.

*Applicability Dates:* For dates of applicability of these regulations, see §§1.1502–9A(a)(1) and (b)(1) and 1.1502–9(e).

FOR FURTHER INFORMATION CONTACT: Trina Dang of the Office of Associate Chief Counsel (International), (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

## Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under the control number 1545–1634. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

The estimated annual burden per respondent is 1.5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained so long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### Background

On December 29, 1998, the IRS and Treasury published in the **Federal Register** (REG–106902–98, 63 F.R. 71589 [1999–8 I.R.B. 57]) a notice of proposed rulemaking modifying the rules relating to the treatment of overall foreign loss (OFL) accounts, and providing new rules relating to the treatment of separate limitation loss (SLL) accounts. The regulations proposed to replace the notional account method for allocating a group's consolidated OFL (COFL) account to a departing member of a group with an asset-based method for allocating both OFLs and SLLs. The regulations also proposed to modify the section 904(f)(3) and (5)(F) disposition rules in the case of intercompany transactions, and to provide computational rules and nomenclature for SLLs as well as OFLs.

A public hearing was held on February 17, 1999, and two written comments

were received. One commentator recommended the retention of the notional account method because the asset-based method can result in the allocation of a portion of the COFL account to a departing member that did not contribute to the COFL account, a result that the commentator views as arbitrary. To alleviate the tension between the interest allocation and COFL rules, the commentator suggested amending the interest allocation rules instead of the COFL rules.

Treasury and the IRS recognize that, under the asset-based method, a portion of a COFL account can under certain circumstances be allocated to a member that did not directly contribute to the COFL account (because, for example, it was not a member of the group at the time the OFL arose). However, as noted in the preamble to regulations issued in January 1998 that eliminated the limitation on OFL recapture and foreign tax credit utilization with respect to separate return limitation years, any single member's economic "contribution" to a COFL account is difficult to measure since the expense allocation rules require interest and certain other expenses to be allocated to a member's income in separate limitation categories on the basis of the group's assets.

An asset-based method is not arbitrary because it associates a COFL account with assets that will produce income subject to recapture, thereby ensuring the recapture of the COFL account. As explained in the preamble to the proposed regulations, Treasury and the IRS believe that the asset-based method for allocating a COFL account harmonizes the COFL rules with the interest allocation provisions. Those provisions, as required by statute, are designed to prevent corporations from borrowing in ways that inappropriately minimize the amount of interest expense allocated against foreign-source income (thereby inflating the amount of foreign-source income that can be sheltered from U.S. tax by foreign tax credits).

The commentator also criticized the asset-based method for allocating COFL accounts as creating uncertainty and administrative burdens in determining the proper amount of a selling group's COFL account to be apportioned to a departing

member at the time a member is acquired. Treasury and the IRS recognize that the asset-based method may result in greater uncertainty under certain circumstances. It is anticipated that a taxpayer acquiring a member of a consolidated group may address any uncertainties as to the proper allocation of a COFL account by entering into a tax indemnity or similar agreement. It is also noted that, even under the notional account method, a COFL account apportioned to a departing member cannot be determined with certainty at the time of the acquisition because the apportionment is made at the end of the taxable year during which the member departs the group. Treasury and the IRS recognize that the new rules may result in an increased burden for certain taxpayers, but have concluded that the possibility of an increased burden is not sufficient to warrant the retention of the notional account method in light of severe distortions created by the interaction of the notional account method and the interest expense allocation provisions.

Another commentator requested a transition rule under which the notional account method would continue to apply to a group's existing COFL account that would not be a part of the group's account had the asset-based allocation method been in effect in prior years. The commentator argued that a transition rule is necessary because taxpayers can be adversely affected by the transition from the old rules to the new rules.

The final regulations do not adopt this transition rule because of administrative and equity concerns. The rule would be difficult to administer because a taxpayer would be required to ascertain asset values of all members that departed the group (on the date that the member departed) going back a number of years in order to apply the asset-based allocation method. Additionally, keeping track of the grandfathered account on a prospective basis and distinguishing it from non-grandfathered accounts could add significant complexity.

Furthermore, it is not clear whether the commentator's suggested transition rule generally produces equitable results. Under the suggested transition rule, no portion of the group's COFL account that would not be a part of the group's account had the new rules applied in earlier years

would be allocated to a departing member that has foreign assets but that does not have a notional account. Treasury and the IRS are not convinced that it would be more equitable for the group to bear the burden of the COFL account under these circumstances.

A question has been raised regarding whether the asset-based method for allocating COFL accounts to a departing member also applies to an affiliated group that does not file a consolidated return. Because the interest expense allocation rules apply to affiliated groups, these rules can result under certain circumstances in the creation of OFL accounts in members with no foreign assets. Section 904(i) is an anti-abuse rule intended to prevent an affiliated group from circumventing the consolidated return rules to avoid the foreign tax credit limitation provisions. Under §1.904(i)-1, each member of an affiliated group determines its taxable income for each separate limitation income category under section 904(d) and then combines those amounts to determine one amount of income for the group in each income category. The consolidated return regulations that apply the principles of sections 904(f) and 907(c)(4) will then be applied to the combined amounts in each separate category as if all affiliates were members of a single consolidated group. By reason of the section 904(i) regulations, the asset-based method for allocating the appropriate portion of a group's COFL account to a departing member applies to an affiliated group of corporations that does not file returns on a consolidated basis.

A question has also been raised as to whether the tax book value of assets is affected for purposes of COFL apportionment if a member's departure from a group causes the group to take into account in computing consolidated taxable income gain or loss on assets transferred in intercompany transactions. To prevent apportionment of a disproportionate amount of the COFL account to a departing member, §1.1502-9(c)(2)(ii) of the final regulations clarifies that the computation of the tax book value of assets for purposes of such apportionment shall be determined without regard to previously deferred gain or loss that is taken into account as a result of the member's departure from the group (because, for exam-

ple, of the acceleration rule under §1.1502-13(d)).

After full consideration of all questions and comments, the proposed regulations published in the **Federal Register** on December 29, 1998 (REG-106902-98, 63 F.R. 71589) are adopted by this Treasury decision without substantive amendment.

### *Special Analyses*

It has been determined that this regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory impact analysis is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations principally affect corporations filing consolidated federal income tax returns that have overall foreign losses or separate limitation losses. Available data indicates that many consolidated return filers are large companies (not small businesses). In addition, the data indicates that an insubstantial number of consolidated return filers that are smaller companies have overall foreign losses or separate limitation losses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

### *Drafting Information*

The principal author of this regulation is Trina Dang of the Office of Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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### *Adoption of Amendments to the Regulations*

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry

for §1.1502-9T and by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.1502-9 also issued under 26 U.S.C. 1502. \* \* \*

Section 1.1502-9A also issued under 26 U.S.C. 1502. \* \* \*

Par. 2. In §1.1502-3T, paragraph (c)(4), the first sentence is amended by removing the language “1.1502-9T(b)-(1)(v)” and adding “1.1502-9A(b)(1)(v)” in its place, and revising the last sentence to read as follows:

*§1.1502-3T Consolidated investment credit (temporary).*

\* \* \* \* \*

(c) \* \* \*

(4) \* \* \* However, a consolidated group making the election provided in §1.1502-9A(b)(1)(vi) (electing not to apply §1.1502-9A(b)(1)(v) to years beginning before January 1, 1998) may nevertheless choose to apply all such paragraphs other than §1.1502-9A(b)(1)(v) for all relevant years.

\* \* \* \* \*

Par. 3. Immediately following §1.1504-4 an undesignated center heading is added to read as follows:

REGULATIONS APPLICABLE FOR  
TAX YEARS FOR WHICH A RE-  
TURN IS DUE ON OR BEFORE AU-  
GUST 11, 1999

Par. 4. Section 1.1502-9 is redesignated as §1.1502-9A and transferred under the new undesignated center heading set out in Par. 3. above.

Par. 5. Newly designated §1.1502-9A is amended by:

1. Revising the section heading.

2. Redesignating the paragraph heading and text of paragraph (a) as the paragraph heading and text of paragraph (a)(2).

3. Adding a new paragraph heading for paragraph (a), and new paragraphs (a)(1), (b)(1)(v) and (b)(1)(vi).

The revisions and additions read as follows:

*§1.1502-9A Application of overall foreign loss recapture rules to corporations filing consolidated returns due on or before August 11, 1999.*

(a) *Scope*—(1) *Effective date*. This section applies only to consolidated return

years for which the due date of the income tax return (without extensions) is on or before August 11, 1999.

(2) *In general*. \* \* \*

(b) \* \* \*

(1) \* \* \*

(v) *Special effective date for SRLY limitation*. Except as provided in paragraph (b)(1)(vi) of this section, paragraphs (b)(1)(iii) and (iv) of this section apply only to consolidated return years for which the due date of the income tax return (without extensions) is on or before March 13, 1998. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, the rules of paragraph (b)(1)(ii) of this section shall apply to overall foreign losses from separate return years that are separate return limitation years. For purposes of applying paragraph (b)(1)(ii) of this section in such years, the group treats a member with a balance in an overall foreign loss account from a separate return limitation year on the first day of the first consolidated return year for which the due date of the income tax return (without extensions) is after March 13, 1998, as a corporation joining the group on such first day. An overall foreign loss that is part of a net operating loss or net capital loss carryover from a separate return limitation year of a member that is absorbed in a consolidated return year for which the due date of the income tax return (without extensions) is after March 13, 1998, shall be added to the appropriate consolidated overall foreign loss account in the year that it is absorbed. For consolidated return years for which the due date of the income tax return (without extensions) is after March 13, 1998, similar principles apply to overall foreign losses when there has been a consolidated return change of ownership (regardless of when the change of ownership occurred). See also §1.1502-3T(c)-(4) for an optional effective date rule (generally making this paragraph (b)(1)(v) applicable to a consolidated return year beginning after December 31, 1996, if the due date of the income tax return (without extensions) for such year is on or before March 13, 1998).

(vi) *Election to defer application of special effective date*. A consolidated group may elect not to apply paragraph (b)(1)(v) of this section to consolidated

return years beginning before January 1, 1998. To make this election, a consolidated group must write “Election Pursuant to Notice 98-40” across the top of page 1 of an original or amended tax return for each consolidated return year subject to the election. For the first consolidated return year to which the overall foreign loss provisions of paragraph (b)(1)(v) of this section apply (i.e., the first year beginning on or after January 1, 1998), such consolidated group must write “Notice 98-40 Election in Effect in Prior Years” across the top of page 1 of the consolidated tax return for that year. For purposes of applying paragraph (b)(1)(ii) of this section with respect to such year, any member with a balance in an overall foreign loss account from a separate return limitation year on the first day of such year shall be treated as joining the group on such first day.

\* \* \* \* \*

Par. 6. New §1.1502-9 is added to read as follows:

*§1.1502-9 Consolidated overall foreign losses and separate limitation losses.*

(a) *In general*. This section provides rules for applying section 904(f) (including its definitions and nomenclature) to a group and its members. Generally, section 904(f) concerns rules relating to overall foreign losses (OFLs) and separate limitation losses (SLLs) and the consequences of such losses. As provided in section 904(f)(5), losses are computed separately in each category of income described in section 904(d)(1) (basket). Paragraph (b) of this section defines terms and provides computational and accounting rules, including rules regarding recapture. Paragraph (c) of this section provides rules that apply to OFLs and SLLs when a member becomes or ceases to be a member of a group. Paragraph (d) of this section provides a predecessor and successor rule. Paragraph (e) of this section provides effective dates.

(b) *Consolidated application of section 904(f)*. A group applies section 904(f) for a consolidated return year in accordance with that section, subject to the following rules:

(1) *Computation of CSLI or CSLL and consolidated U.S. source income or loss*.



The group computes its consolidated separate limitation income (CSLI) or consolidated separate limitation loss (CSLL) for each basket under the principles of §1.1502-11 by aggregating each member's foreign-source taxable income or loss in such basket computed under the principles of §1.1502-12, and taking into account the foreign portion of the consolidated items described in §1.1502-11(a)-(2) through (8) for such basket. The group computes its consolidated U.S.-source taxable income or loss under similar principles.

(2) *Netting CSLLs, CSLIs, and consolidated U.S. source taxable income or loss.* The group applies section 904(f)(5) to determine the extent to which a CSLL for a basket reduces CSLI for another basket or consolidated U.S.-source taxable income.

(3) *CSLL and COFL accounts.* To the extent provided in section 904(f), the amount by which a CSLL for a basket (the loss basket) reduces CSLI for another basket (the income basket) shall result in the creation of (or addition to) a CSLL account for the loss basket with respect to the income basket. Likewise, the amount by which a CSLL for a loss basket reduces consolidated U.S.-source income will create (or add to) a consolidated overall foreign loss account (a COFL account).

(4) *Recapture of COFL and CSLL accounts.* In the case of a COFL account for a loss basket, section 904(f)(1) and (3) recharacterizes some or all of the foreign-source income in the loss basket as U.S.-source income. In the case of a CSLL account for a loss basket with respect to an income basket, section 904(f)(5)(C) and (F) recharacterizes some or all of the foreign-source income in the loss basket as foreign-source income in the income basket. The COFL account or CSLL account is reduced to the extent amounts are recharacterized with respect to such account.

(5) *Intercompany transactions—(i) Nonapplication of section 904(f) disposition rules.* Neither section 904(f)(3) (in the case of a COFL account) nor (5)(F) (in the case of a CSLL account) applies at the time of a disposition that is an intercompany transaction to which §1.1502-13 applies. Instead, section 904(f)(3) and (5)(F) applies only at such time and only to the extent that the group is required under §1.1502-13 (without regard to sec-

tion 904(f)(3) and (5)(F)) to take into account any intercompany items resulting from the disposition, based on the COFL or CSLL account existing at the end of the consolidated return year during which the group takes the intercompany items into account.

(ii) *Example.* Paragraph (b)(5)(i) of this section is illustrated by the following examples. The identity of the parties and the basic assumptions set forth in §1.1502-13(c)(7)(i) apply to the examples. Except as otherwise stated, assume further that the consolidated group recognizes no foreign-source income other than as a result of the transactions described. The examples are as follows:

*Example 1.* (i) On June 10, Year 1, S transfers nondepreciable property with a basis of \$100 and a fair market value of \$250 to B in a transaction to which section 351 applies. The property was predominantly used without the United States in a trade or business, within the meaning of section 904(f)(3). B continues to use the property without the United States. The group has a COFL account in the relevant loss basket of \$120 as of December 31, Year 1.

(ii) Because the contribution from S to B is an intercompany transaction, section 904(f)(3) does not apply to result in any gain recognition in Year 1. See paragraph (b)(5)(i) of this section.

(iii) On January 10, Year 4, B ceases to be a member of the group. Because S did not recognize gain in Year 1 under section 351, no gain is taken into account in Year 4 under §1.1502-13(d). Thus, no portion of the group's COFL account is recaptured in Year 4. For rules requiring apportionment of a portion of the COFL account to B, see paragraph (c)(2) of this section.

*Example 2.* (i) The facts are the same as in paragraph (i) of *Example 1*. On January 10, Year 4, B sells the property to X for \$300. As of December 31, Year 4, the group's COFL account is \$40. (The COFL account was reduced between Year 1 and Year 4 due to unrelated foreign-source income taken into account by the group.)

(ii) B takes into account gain of \$200 in Year 4. The \$40 COFL account in Year 4 recharacterizes \$40 of the gain as U.S. source. See section 904(f)(3).

*Example 3.* (i) On June 10, Year 1, S sells nondepreciable property with a basis of \$100 and a fair market value of \$250 to B for \$250 cash. The property was predominantly used without the United States in a trade or business, within the meaning of section 904(f)(3). The group has a COFL account in the relevant loss basket of \$120 as of December 31, Year 1. B predominately uses the property in a trade or business without the United States.

(ii) Because the sale is an intercompany transaction, section 904(f)(3) does not require the group to take into account any gain in Year 1. Thus, under paragraph (b)(5)(i) of this section, the COFL account is not reduced in Year 1.

(iii) On January 10, Year 4, B sells the property to X for \$300. As of December 31, Year 4, the group's

COFL account is \$60. (The COFL account was reduced between Year 1 and Year 4 due to unrelated foreign-source income taken into account by the group.)

(iv) In Year 4, S's \$150 intercompany gain and B's \$50 corresponding gain are taken into account to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation. See §1.1502-13(c). All of B's \$50 corresponding gain is recharacterized under section 904(f)(3). If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$100 basis in the property and would have \$200 of gain (\$60 of which would be recharacterized under section 904(f)(3)), instead of a \$50 gain. Consequently, S's \$150 intercompany gain and B's \$50 corresponding gain are taken into account, and \$10 of S's gain is recharacterized under section 904(f)(3) as U.S. source to reflect the \$10 difference between B's \$50 recharacterized gain and the \$60 recomputed gain that would have been recharacterized.

(c) *Becoming or ceasing to be a member of a group—(1) Adding separate accounts on becoming a member.* At the time that a corporation becomes a member of a group (a new member), the group adds to the balance of its COFL or CSLL account the balance of the new member's corresponding OFL account or SLL account. A new member's OFL account corresponds to a COFL account if the account is for the same loss basket. A new member's SLL account corresponds to a CSLL account if the account is for the same loss basket and with respect to the same income basket. If the group does not have a COFL or CSLL account corresponding to the new member's account, it creates a COFL or CSLL account with a balance equal to the balance of the member's account.

(2) *Apportionment of consolidated account to departing member—(i) In general.* A group apportions to a member that ceases to be a member (a departing member) a portion of each COFL and CSLL account as of the end of the year during which the member ceases to be a member and after the group makes the additions or reductions to such account required under paragraphs (b)(3), (b)(4) and (c)(1) of this section (other than an addition under paragraph (c)(1) of this section attributable to a member becoming a member after the departing member ceases to be a member). The group computes such portion under paragraph (c)(2)(ii) of this section, as limited by paragraph (c)(2)(iii) of this section. The departing member carries such portion to

its first separate return year after it ceases to be a member. Also, the group reduces each account by such portion and carries such reduced amount to its first consolidated return year beginning after the year in which the member ceases to be a member. If two or more members cease to be members in the same year, the group computes the portion allocable to each such member (and reduces its accounts by such portion) in the order that the members cease to be members.

(ii) *Departing member's portion of group's account.* A departing member's portion of a group's COFL or CSLL account for a loss basket is computed based upon the member's share of the group's assets that generate income subject to recapture at the time that the member ceases to be a member. Under the characterization principles of §§1.861-9T(g)(3) and 1.861-12T, the group identifies the assets of the departing member and the remaining members that generate foreign-source income (foreign assets) in each basket. The assets are characterized based upon the income that the assets are reasonably expected to generate after the member ceases to be a member. The member's portion of a group's COFL or CSLL account for a loss basket is the group's COFL or CSLL account, respectively, multiplied by a fraction, the numerator of which is the value of the member's foreign assets for the loss basket and the denominator of which is the value of the foreign assets of the group (including the departing member) for the loss basket. The value of the foreign assets is determined under the asset valuation rules of §1.861-9T(g)(1) and (2) using either tax book value or fair market value under the method chosen by the group for purposes of interest apportionment as provided in §1.861-9T(g)(1)(ii). For purposes of this paragraph (c)(2)(ii), §1.861-9T(g)(2)(iv) (assets in intercompany transactions) shall apply, but §1.861-9T(g)(2)(iii) (adjustments for directly allocated interest) shall not apply. If the group uses the tax book value method, the member's portions of COFL and CSLL accounts are limited by paragraph (c)(2)(iii) of this section. In addition, for purposes of this paragraph (c)(2)(ii), the tax book value of assets transferred in intercompany transactions shall be determined without regard to previously deferred gain or loss

that is taken into account by the group as a result of the transaction in which the member ceases to be a member. The assets should be valued at the time the member ceases to be a member, but values on other dates may be used unless this creates substantial distortions. For example, if a member ceases to be a member in the middle of the group's consolidated return year, an average of the values of assets at the beginning and end of the year (as provided in §1.861-9T(g)(2)) may be used or, if a member ceases to be a member in the early part of the group's consolidated return year, values at the beginning of the year may be used, unless this creates substantial distortions.

(iii) *Limitation on member's portion for groups using tax book value method.* If a group uses the tax book value method of valuing assets for purposes of paragraph (c)(2)(ii) of this section and the aggregate of a member's portions of COFL and CSLL accounts for a loss basket (with respect to one or more income baskets) determined under paragraph (c)(2)(ii) of this section exceeds 150 percent of the actual fair market value of the member's foreign assets in the loss basket, the member's portion of the COFL or CSLL accounts for the loss basket shall be reduced (proportionately, in the case of multiple accounts) by such excess. This rule does not apply if the departing member and all other members that cease to be members as part of the same transaction own all (or substantially all) the foreign assets in the loss basket.

(iv) *Determination of values of foreign assets binding on departing member.* The group's determination of the value of the member's and the group's foreign assets for a loss basket is binding on the member, unless the Commissioner concludes that the determination is not appropriate. The common parent of the group must attach a statement to the return for the taxable year that the departing member ceases to be a member of the group that sets forth the name and taxpayer identification number of the departing member, the amount of each COFL or CSLL for each loss basket that is apportioned to the departing member under this paragraph (c)(2), the method used to determine the value of the member's and the group's foreign assets in each such loss basket, and the value of the member's and the

group's foreign assets in each such loss basket. The common parent must also furnish a copy of the statement to the departing member.

(v) *Anti-abuse rule.* If a corporation becomes a member and ceases to be a member, and a principal purpose of the corporation becoming and ceasing to be a member is to transfer the corporation's OFL account or SLL account to the group or to transfer the group's COFL or CSLL account to the corporation, appropriate adjustments will be made to eliminate the benefit of such a transfer of accounts. Similarly, if any member acquires assets or disposes of assets (including a transfer of assets between members of the group and the departing member) with a principal purpose of affecting the apportionment of accounts under paragraph (c)(2)(i) of this section, appropriate adjustments will be made to eliminate the benefit of such acquisition or disposition.

(vi) *Examples.* The following examples illustrate this paragraph (c):

*Example 1.* (i) On November 6, Year 1, S, a member of the P group, a consolidated group with a calendar consolidated return year, ceases to be a member of the group. On December 31, Year 1, the P group has a \$40 COFL account for the general limitation basket, a \$20 CSLL account for the general limitation basket (i.e., the loss basket) with respect to the passive basket (i.e., the income basket), and a \$10 CSLL account for the shipping income basket (i.e., the loss basket) with respect to the passive basket (i.e., the income basket). No member of the group has foreign-source income or loss in Year 1. The group apportions its interest expense according to the tax book value method.

(ii) On November 6, Year 1, the group identifies S's assets and its own assets (including S's assets) expected to produce foreign general limitation income. Use of end-of-the-year values will not create substantial distortions in determining the relative values of S's and the group's relevant assets on November 6, Year 1. The group determines that S's relevant assets have a tax book value of \$2,000 and a fair market value of \$2,200. Also, the group's relevant assets (including S's assets) have a tax book value of \$8,000. On November 6, Year 1, S has no assets expected to produce foreign shipping income.

(iii) Under paragraph (c)(2)(ii) of this section, S takes a \$10 COFL account for the general limitation basket ( $\$40 \times \$2000/\$8000$ ) and a \$5 CSLL account for the general limitation basket with respect to the passive basket ( $\$20 \times \$2000/\$8000$ ). S does not take any portion of the shipping income basket CSLL account. The limitation described in paragraph (c)(2)(iii) of this section does not apply because the aggregate of the COFL and CSLL accounts for the general limitation basket that are apportioned to S (\$15) is less than 150 percent of the actual fair market value of S's general limitation foreign assets ( $\$2,200 \times 150\%$ ).

*Example 2.* (i) Assume the same facts as in *Example 1*, except that the fair market value of S's general limitation foreign assets is \$4 as of November 6, Year 1.

(ii) Under paragraph (c)(2)(iii) of this section, S's COFL and CSLL accounts for the general limitation basket must be reduced by \$9, which is the excess of \$15 (the aggregate amount of the accounts apportioned under paragraph (c)(2)(ii) of this section) over \$6 (150 percent of the \$4 actual fair market value of S's general limitation foreign assets). S thus takes a \$4 COFL account for the general limitation basket (\$10 - (\$9 × \$10/\$15)) and a \$2 CSLL account for the general limitation basket with respect to the passive basket (\$5 - (\$9 × \$5/\$15)).

(d) *Predecessor and successor.* A reference to a member includes, as the context may require, a reference to a predecessor or successor of the member. See §1.1502-1(f).

(e) *Effective dates.* This section applies to consolidated return years for which the due date of the income tax return (without extensions) is after August 11, 1999. However, paragraph (b)(5) of this section (intercompany transactions) is not applicable for intercompany transactions that occur before January 28, 1999. A group applies the principles of §1.1502-9A(e) to a disposition which is an intercompany transaction to which §1.1502-13 applies and that occurs before January 28, 1999. Also, paragraph (c)(2) of this section (apportionment of consolidated account to departing member) is not applicable for members ceasing to be members of a group before January 28, 1999. A group applies the principles of §1.1502-9A (rather than paragraph (c)(2) of this section) to determine the amount of a consolidated account that is apportioned to a member that ceases to be a member of the

group before January 28, 1999 (and reduces its consolidated account by such apportioned amount) before applying paragraph (c)(2) of this section to members that cease to be members on or after January 28, 1999.

# **§1.1502-9T [Removed]**

Par. 7. Section 1.1502-9T is removed.

## **PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. In §602.101, paragraph (b) is amended in the table by removing the current entry for 1.1502-9 and adding new entries for 1.1502-9 and 1.1502-9A to read as follows:

### *§602.101 OMB Control numbers.*

\* \* \* \* \*

(b) \* \* \*

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1502-9 . . . . .	1545-1634
* * * * *	
1.1502-9A . . . . .	1545-0121
* * * * *	

Robert E. Wenzel,  
*Deputy Commissioner of Internal Revenue.*

Approved July 16, 1999.

Donald C. Lubick,  
*Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on August 10, 1999, 8:45 a.m., and published in the issue of the Federal Register for August 11, 1999, 64 F.R. 43613)

## **Section 7520.—Valuation Tables**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, page 336.

## **Section 7872.—Treatment of Loans With Below-Market Interest Rates**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1999. See Rev. Rul. 99-37, page 336.



## Part III. Administrative, Procedural, and Miscellaneous

### Rule to be Included in Final Regulations Under Section 897(e) of the Code

#### Notice 99-43

This notice announces a modification of the current rules under Temp. Reg. §1.897-6T(a)(1) regarding transfers, exchanges, and other dispositions of U.S. real property interests in nonrecognition transactions occurring after June 18, 1980. The new rule will be included in regulations finalizing the temporary regulations.

#### SECTION I. BACKGROUND

Section 897(a) of the Code provides generally that the disposition of a U.S. real property interest by a nonresident alien individual or a foreign corporation is taxable as effectively connected income under section 871(b)(1) or section 882(a)(1), respectively, as if the taxpayer was engaged in a trade or business within the United States and the gain or loss was effectively connected with the trade or business.

Section 897(c)(1) of the Code defines a U.S. real property interest as including an interest (other than an interest solely as a creditor) in any domestic corporation, unless the taxpayer establishes that such corporation was at no time a U.S. real property holding corporation during the shorter of the period the taxpayer held such interest or the 5-year period ending on the date of the disposition of such interest. Under section 897(c)(2), a U.S. real property holding corporation is defined as any corporation if the fair market value of its U.S. real property interests equals or exceeds 50-percent of the sum of (i) its U.S. real property interests, (ii) its real property interests located outside the United States, and (iii) any of its other assets used or held for use in a trade or business.

Section 897(e)(1) of the Code provides generally that a nonrecognition provision applies only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under Chapter 1 of the Code. Under section 897(e)(2), the Secretary may prescribe

regulations providing the extent to which nonrecognition provisions apply to transfers of U.S. real property interests.

Pursuant to the regulatory authority under section 897(e)(2), Temp. Reg. §1.897-6T(a)(1) provides that, subject to certain exceptions, any nonrecognition provision shall apply to a transfer by a foreign person of a U.S. real property interest on which gain is realized only to the extent that the transferred U.S. real property interest is exchanged for a U.S. real property interest which, immediately following the exchange, would be subject to U.S. taxation upon its disposition (and the transferor complies with the filing requirement of Temp. Reg. §1.897-5). In the case of an exchange of a U.S. real property interest for stock in a domestic corporation (that is otherwise treated as a U.S. real property interest), such stock shall not be considered a U.S. real property interest unless the domestic corporation is a U.S. real property holding corporation immediately after the exchange. Thus, if an interest in a U.S. real property holding corporation is exchanged in a nonrecognition transaction for stock of a domestic corporation, that is not a U.S. real property holding corporation immediately after the exchange, the exchange would be taxable under section 897.

Under Temp. Reg. §1.897-6T(a)(2), a nonrecognition provision for purposes of section 897(e) is any provision of the Code which provides that gain or loss is not recognized if the requirements of that provision are met. Thus, section 897(e) applies only to an exchange that receives nonrecognition treatment pursuant to another provision of the Code and does not create (or expand) a nonrecognition provision.

#### SECTION II. FINALIZATION OF TEMP. REG. §1.897-6T(a)(1)

It is recognized that the requirement in Temp. Reg. §1.897-6T(a)(1), providing that the corporation whose stock is received in a nonrecognition exchange must be a U.S. real property holding corporation immediately after the exchange, may not be appropriate for stock exchanges under section 354(a) in certain reorganizations described in sections 368(a)(1)(E)

and (F) of the Code. This may be illustrated by two examples. In both examples, the corporation, the stock of which was received in the exchange, is not a U.S. real property holding corporation immediately after the exchange, but was a U.S. real property holding corporation within the period provided in section 897(c)(1)(A)(ii) (the shorter of five years or the taxpayer's holding period prior to the exchange).

In example one, a domestic corporation engages in a recapitalization, whereby one share of common stock is issued in exchange for two outstanding shares of the existing common stock (in what is commonly referred to as a "reverse stock split"), pursuant to a section 354(a) exchange in a section 368(a)(1)(E) reorganization. The shares received in the exchange are substantially identical to the shares exchanged therefor, possessing (in the aggregate and with respect to any other outstanding stock of the corporation) the same dividend rights, voting power, liquidation preference (if any), convertibility and other legal and economic entitlements as the shares exchanged, and do not contain any additional rights or obligations.

In example two, a domestic corporation changes its state of incorporation from State A to State B, pursuant to a state law merger of the corporation into a corporation newly incorporated in State B solely to facilitate the transaction, and which is the survivor in the merger. In the merger, stock of the merged corporation is exchanged for stock in the surviving corporation, possessing (in the aggregate and with respect to any other outstanding stock of the corporation) substantially identical dividend rights, voting power, liquidation preference (if any), convertibility and other legal and economic entitlements as the shares exchanged, and does not contain any additional rights or obligations. The reincorporation qualifies as a reorganization under section 368(a)(1)(F).

Under Temp. Reg. §1.897-6T(a)(1), the exchange of stock in both examples would be taxable to foreign shareholders because, with respect to the interests exchanged, the domestic corporation whose



stock is received is not a U.S. real property holding corporation immediately after the exchange. Accordingly, when the final regulations under section 897(e) are issued, the regulations will include an exception that will provide that a foreign taxpayer will not recognize gain under section 1.897-6T(a)(1) (as finalized) for a stock exchange under section 354(a) in certain reorganizations described in section 368(a)(1)(E) or (F). The exception will apply where the taxpayer receives stock in the corporation that is substantially identical to the shares exchanged, possessing (in the aggregate and with respect to any other outstanding stock of the corporation) the same dividend rights, voting power, liquidation preferences (if any), and convertibility as the shares exchanged without any additional rights or obligations.

The final regulations will provide, for purposes of section 897(a) and (e), that stock received in a section 368(a)(1)(E) or (F) reorganization qualifying for nonrecognition pursuant to section 354(a) under the examples described above, constitutes the same interest in the corporation whose stock was exchanged for purposes of determining whether the interest received is a U.S. real property interest under section 897(c)(1)(A)(ii). Thus, the determination of whether the interest received in such an exchange is a U.S. real property interest under section 897(c)(1)(A)(ii) will include the period prior to the exchange.

For example, if a foreign person receives substantially identical stock in a section 354(a) exchange pursuant to the recapitalization of a domestic corporation that qualifies as a reorganization within

the meaning of section 368(a)(1)(E), and the corporation ceased to be a U.S. real property holding corporation two years prior to the exchange, the sale of the stock by the foreign person two years after the exchange will constitute the disposition of a U.S. real property interest that is subject to tax under section 897(a). If the same interest were to be sold by the foreign person four years after the exchange, the sale would not be subject to tax under section 897(a), because the interest would not have been a U.S. real property interest. In such case, the interest would not have been an interest in a domestic corporation that was a U.S. real property holding corporation during the period specified in section 897(c)(1)(A)(ii).

The rule described in this notice is effective for transfers occurring on or after September 6, 1999 (the date of publication of this notice), although a taxpayer may elect to apply the rule of this notice to transfers occurring after June 18, 1980.

### SECTION III. PAPERWORK REDUCTION ACT

The collections of information required by this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1660.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information required by this notice are in Temp. Reg. §1.897-

6T(a)(1) and 1.897-5T(d)(1)(iii), Treas. Reg. §1.1445-2(d)(2)(i)(A) and Temp. Reg. §1.1445-9T. This information will be used to obtain exemptions from tax under certain nonrecognition transactions and to satisfy reporting requirements regarding these nonrecognition transactions. This information will be used by the Internal Revenue Service to verify whether a taxpayer is entitled to exemption from tax under a nonrecognition transaction. The likely respondents are individuals, corporations, and business or other for-profit institutions.

The estimated total annual reporting burden is 200 hours. The estimated annual burden per respondent is 2 hours. The estimated number of respondents is 100. The estimated frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### SECTION IV. DRAFTING INFORMATION

The principal author of this notice is Robert Lorence of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Mr. Lorence at (202) 622-3860 (not a toll-free call). Comments are requested regarding this Notice, including the application of the exception to be provided for in the final regulations as described herein to other nonrecognition transactions.

## Part IV. Items of General Interest

### Notice of Proposed Rulemaking and Notice of Public Hearing

#### Purchase Price Allocations in Deemed Actual Asset Acquisitions

REG-107069-97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the allocation of purchase price in deemed and actual asset acquisitions. The proposed regulations determine the amount realized and the amount of basis allocated to each asset transferred in a deemed or actual asset acquisition and affect transactions reported on either Form 8023 or Form 8594.

DATES: Written comments must be received by September 20, 1999. Requests to speak and outlines of topics to be discussed at the hearing scheduled for 10 a.m., October 12, 1999, must be received by September 20, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-107069-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG-107069-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.ustreas.gov/tax\\_regs/regslst.html](http://www.irs.ustreas.gov/tax_regs/regslst.html). The public hearing will be held in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations,

Richard Starke, (202) 622-7790 or Stephen R. Wegener, (202) 622-7530; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy R. Traynor (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### *Paperwork Reduction Act*

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collections of information should be received by October 12, 1999. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the IRS, including whether the collections will have a practical utility;

The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in these proposed regulations are in §§1.338-2(d), 1.338-2(e)(4), 1.338-5(d)(3), 1.338-10(a)(4), 1.338(h)(10)-1(d)(2), and 1.1060-1(e)(ii)(A) and (B). The collections of information are necessary to

make an election to treat a sale of stock as a sale of assets, to calculate and collect the appropriate amount of tax in a deemed or actual asset acquisition, and to determine the bases of assets acquired in a deemed or actual asset acquisition.

These collections of information are required to obtain a benefit. The likely respondents and/or recordkeepers are small businesses or organizations, businesses, or other for-profit institutions, and farms.

The regulation provides that a section 338 election is made by filing Form 8023. The burden for this requirement is reflected in the burden of Form 8023. The regulation also provides that both a seller and a purchaser must each file an asset acquisition statement on Form 8594. The burden for this requirement is reflected in the burden of Form 8594. The burden for the collection of information in §1.338-2(e)(4) is as follows:

Estimated total annual reporting/record-keeping burden: 25 hours

Estimated average annual burden per respondent/recordkeeper: 0.56 hours

Estimated number of respondents/recordkeepers: 45

Estimated annual frequency of responses: On occasion

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

#### *Background*

##### *A. Evolution of Code and Regulations.*

Section 338 was added to the Internal Revenue Code of 1954 (Code) by section 224(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248 (96 Stat. 324), and amended by section 306(a)(8) of the Technical Corrections Act of 1982, Public Law 97-448 (96 Stat. 2365), and further amended by section 712(k) of the Tax Reform Act of 1984, Public Law 98-369 (98 Stat. 951).

Section 338 replaces any nonstatutory treatment of a stock purchase as an asset purchase by allowing certain acquiring corporations to elect to treat qualifying stock purchases as asset acquisitions.

General rules for making elections under section 338 were first issued in temporary regulations §§5f.338-1, 5f.338-2, and 5f.338-3 published as T.D. 7942 in the **Federal Register** on February 8, 1984 (49 F.R. 4722 [1984-1 C.B. 93]). Those rules were amended and redesignated as §§1.338-1T, 1.338-2T, and 1.338-3T by temporary regulations published as T.D. 7975 in the **Federal Register** on September 6, 1984 (49 F.R. 35086 [1984-2 C.B. 81]).

Treasury Decision 8021, published in the **Federal Register** on April 25, 1985 (50 F.R. 16402 [1985-1 C.B. 96]), amended §§1.338-1T and 1.338-2T and added §1.338-4T. These regulations provided guidance in a question and answer format, most notably in the areas of asset and stock consistency requirements.

Temporary regulations published as T.D. 8068 in the **Federal Register** on January 8, 1986 (51 F.R. 741 [1986-1 C.B. 165]), amended §§1.338-1T and 1.338-4T. The temporary regulations published on January 8, 1986 also added §1.338(h)(10)-1T to implement section 338(h)(10), under which a selling consolidated group can elect to treat certain stock sales as asset sales.

Sections 1.338-1T and 1.338-4T were again amended by temporary regulations published as T.D. 8072 in the **Federal Register** on January 29, 1986 (51 F.R. 3583 [1986-1 C.B. 111]). (Due to typesetting errors, the **Federal Register** republished T.D. 8072 in its entirety on March 28, 1986 (51 F.R. 10617)). The temporary regulations published on January 29, 1986 also amended §1.338(h)(10)-1T and added §§1.338(b)-1T, 1.338(b)-2T, and 1.338(b)-3T. These regulations required the selling price and basis allocated to each asset to be determined by using a four class residual method.

On February 12, 1986, temporary regulations published as T.D. 8074 in the **Federal Register** (51 F.R. 5163 [1986-1 C.B. 126]), amended §§1.338-1T, 1.338-4T, and 1.338(h)(10)-1T and added §1.338-5T. These regulations provided guidance on international aspects of section 338.

Sections 1.338-1T, 1.338-2T, 1.338-4T, 1.338-5T, and 1.338(h)(10)-1T were amended by temporary regulations published as T.D. 8088 in the **Federal Register** on May 16, 1986 (51 F.R. 17929 [1986-1 C.B. 103]). Sections 1.338-1T, 1.338-3T, 1.338-4T, 1.338-5T, and 1.338(h)(10)-1T were amended by temporary regulations published as T.D. 8092 in the **Federal Register** on July 1, 1986 (51 F.R. 23741 [1986-2 C.B. 49]). The temporary regulations published on July 1, 1986 also added §1.338(b)-4T. These regulations made miscellaneous conforming changes and transitional rules relating to making and filing section 338 elections.

Section 1060 was added by section 641 of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2282). Section 1060 requires both the buyer and the seller of a trade or business to allocate their consideration paid or received to the assets under the same residual method prescribed by the section 338 regulations. Also as part of the 1986 act, miscellaneous changes were made to section 338 by section 631, 1275, 1804(e), and 1899A (100 Stat. 2269, 2598, 2800, 2958). The changes to section 338 were made to conform section 338 with the repeal of the *General Utilities* doctrine and to define a qualified stock purchase by reference to section 1504.

General guidance under section 1060 was provided by §1.1060-1T, added by temporary regulations published as T.D. 8215 on July 18, 1986 (53 F.R. 27035 [1988-2 C.B. 304]). These regulations included direction on the scope of section 1060 and reiterated the four class residual method found in the section 338 regulations.

Section 1060 was amended by section 1006(h) of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100-647 (102 Stat. 3410). This amendment requires the residual method to be used in the case of a distribution of partnership property or a transfer of an interest in a partnership, but only in determining the value of goodwill or going concern value for purposes of applying section 755. Miscellaneous changes were again made to section 338 by sections 1006(e)(20), 1012(bb)(5)(A), and 1018(d)(9) of the 1988 act (102 Stat. 3403, 3535, 3581).

Sections 338 and 1060 were amended by section 11323 of the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508 (104 Stat. 1388-464). The amendments add certain reporting requirements under sections 338 and 1060. In addition, a provision was added to section 1060 under which parties are bound by written agreements as to allocations or fair market values. The legislative history indicates that the parties are so bound unless the parties can refute the agreement under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967) (by presenting proof which in an action between the parties would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.). See, H.R. Ways and Means Comm., 101st Cong., 2d Sess. (Print No. 101-37, Oct. 15, 1990), at 79.

Temporary regulations published as T.D. 8339 in the **Federal Register** on March 15, 1991 (56 F.R. 11093 [1991-1 C.B. 52]), added §1.338-6T. The March 15, 1991, temporary regulations provided relief from situations in which a corporation making an election under section 338 could be subjected to multiple taxation on the same gain as a result of the 1986 repeal of the *General Utilities* doctrine.

On January 12, 1992, a notice of proposed rulemaking (C0-111-90) under section 338 was published in the **Federal Register** (57 F.R. 1409 [1992-1 C.B. 1000]). The notice of proposed rulemaking contained proposed regulations to replace the question and answer asset and stock consistency rules of §1.338-4T and the rules relating to the international aspects of section 338 found in §1.338-5T. In addition, the proposed rules restated the remainder of the temporary regulations under section 338, except that only minor conforming changes were made to §§1.338(b)-2T and 1.338(b)-3T.

Section 1060 was again amended by section 13261(e) of the Omnibus Budget Reconciliation Act of 1993, Public Law 103-66 (107 Stat. 539). This amendment made changes to section 1060 to conform the rules for actual asset acquisitions to the amortization of intangibles under section 197. In addition, the legislative history to section 197 suggested that the residual method should be altered to ac-



commodate section 197 intangibles (See H.R. Rep. 111, 103d Cong., 1st Sess. 760 (May 23, 1993 [1993-3 C.B. 336])).

Sections 1.338-1T, 1.338-2T, 1.338-3T, 1.338-4T, 1.338-5T, 1.338(b)-1T, and 1.338(h)(10)-1T were revised and replaced by §§1.338-1, 1.338-2, 1.338-3, 1.338-4, 1.338-5, 1.338(b)-1, and 1.338(h)(10)-1, respectively, by final regulations published as T.D. 8515 in the **Federal Register** on January 20, 1994 (59 F.R. 2958 [1994-1 C.B. 89]). The final regulations published on January 20, 1994 (T.D. 8515) also removed §1.338-6T and added §1.338(i)-1. Also, a new §1.338-4T was added by temporary regulations published as T.D. 8516 on January 20, 1994 in the **Federal Register** (59 F.R. 2956 [1994-1 C.B. 119]). The temporary regulations provided consistency rules applicable to certain cases involving controlled foreign corporations.

Treasury Decision 8626 amended §1.338-2 by final regulations published in the **Federal Register** on October 27, 1995 (60 F.R. 54942 [1995-2 C.B. 34]), providing rules governing the treatment of an intragroup merger following a qualified stock purchase of target stock when a section 338 election is not made for the target.

Section 1.338-4 was amended and §1.338-4T was removed by final regulations published as T.D. 8710 in the **Federal Register** on January 23, 1997 (62 F.R. 3458 [1997-1 C.B. 82]).

Sections 1.338(b)-2T, 1.338(b)-3T, and 1.1060-1T were amended by temporary regulations published as T.D. 8711 in the **Federal Register** on January 16, 1997 (62 F.R. 2267 [1997-1 C.B. 85]). The January 16, 1997, changes to the regulations adapted the residual method to section 197 by adding a fifth class to the residual method prescribed for deemed and actual asset acquisitions.

#### B. Current Regulations.

Section 338 allows certain purchasers of stock to treat the purchases instead as purchases of assets. A purchasing corporation can elect to treat a stock acquisition as an asset acquisition if it acquires 80 percent of the total voting power and 80 percent of the total value of the stock of a target corporation (not taking into account certain preferred stock) by purchase within a 12-month period. If a purchasing

corporation makes a section 338 election, the target is treated as if it (as old target) sold all of its assets at the close of the acquisition date at fair market value in a single transaction and (as new target) purchased all of the assets as of the beginning of day after the acquisition date.

If a purchasing corporation acquires the stock of a target corporation in a qualified stock purchase and makes a section 338(g) election (i.e., makes a general section 338 election, not a section 338(h)(10) election), old target's gain or loss from the deemed asset sale is included in old target's final return unless old target is a member of a consolidated group or is an S corporation. In the consolidated and S corporation cases, old target files a special final return including only the items from the deemed asset sale. §1.338-1(e). In the consolidated case, that return is consolidated with neither the selling corporation's nor the purchasing corporation's consolidated group. In the S corporation case, old target must file the special final return as a C corporation. The section 338(g) election (as opposed to a section 338(h)(10) election) generally does not change the tax treatment of the selling shareholders—that is, they are still taxed on their stock sale, notwithstanding the purchasing corporation's section 338(g) election.

In certain cases, the selling shareholders may join with the purchasing corporation in making a section 338(h)(10) election. Until 1994, a section 338(h)(10) election could be made only for target corporations that were members of a consolidated group. The 1994 revisions to the section 338 regulations (effective retroactively to 1992 at taxpayers' election) expanded the eligibility for section 338(h)(10) elections to target corporations that are members of an affiliated group and S corporations. The section 338(h)(10) election changes the tax treatment of old target and the selling shareholders. Old target is deemed to sell all its assets in a single transaction while a member of the selling consolidated group (or while a non-consolidated affiliate, or while an S corporation owned by the selling shareholders) and is deemed immediately thereafter to distribute the proceeds in complete liquidation to the members of the selling consolidated group who sold the target stock (or to the selling affiliate

or to all the S corporation shareholders). Thus, under section 338(h)(10), the selling shareholders are not treated as selling stock but instead realize gain or loss, if any, on the stock in the deemed liquidation. §1.338(h)(10)-1(d)(2). Usually, a selling consolidated group or selling affiliate will recognize no stock gain or loss on the deemed liquidation under section 332. S corporation shareholders will include their share of items of income, gain, loss, or deduction on the deemed asset sale passed through to them under section 1366, increase or decrease their basis accordingly under section 1367, and then recognize any remaining gain or loss in their stock under section 331 (the overall effect of which is to recognize net gain or loss equal to the amount of built-in gain or loss in their S corporation stock immediately before the qualified stock purchase).

In the case of a section 338(g) election, old target's total amount realized for the assets it is deemed to sell (aggregate deemed sale price or ADSP) is the sum of (a) the purchasing corporation's grossed-up basis in recently purchased target stock; (b) the liabilities of new target; and (c) other relevant items. This is the amount to be allocated among the assets sold for purposes of determining gain or loss on the assets. §1.338-3(d)(1) and (2). The liabilities referred to in (b) are those liabilities assumed by new target, but the amount thereof taken into account in ADSP is determined as if old target had sold its assets to an unrelated person for consideration that included the liabilities. The liabilities include any tax liability resulting from the deemed asset sale. §§1.338-3(d)(3) and 1.338(b)-1(f). In the case of a section 338(h)(10) election, ADSP is modified. While not stated explicitly, modified ADSP (MADSP) appears to exclude any tax liabilities resulting from the deemed asset sale. §1.338(h)(10)-1(f).

New target's adjusted grossed-up basis in the assets it is deemed to purchase (AGUB) is the sum of (a) the purchasing corporation's grossed-up basis in recently purchased target stock; (b) the purchasing corporation's basis in nonrecently purchased target stock; (c) the liabilities of new target; and (d) other relevant items. This is the amount to be allocated among the assets sold for purposes of determin-



ing the purchaser's basis in the assets. §1.338(b)-1(c)(1).

Section 1060(a) requires a purchaser and a seller to allocate basis for any applicable asset acquisition in the same manner as amounts are allocated to such assets under section 338(b)(5). Section 1060(c) defines an applicable asset acquisition as any transfer of assets that constitute a trade or business where the transferee's basis is determined wholly by reference to the consideration paid for the assets.

Section 338(b)(5) authorizes the Secretary to issue regulations prescribing how the deemed purchase price is to be allocated among the assets. Final and temporary regulations under sections 338(b) and 1060, as amended, implement this authority. The regulations generally require that the basis of the acquired (or deemed acquired) assets will be determined using a five class residual method. Class I consists of cash and cash equivalents; Class II consists of certificates of deposit, U.S. Government securities, readily marketable stock or securities, and foreign currency; Class III includes all assets not included in Class I, Class II, Class IV, or Class V; Class IV consists of section 197 intangible assets except those in the nature of goodwill and going concern value; and Class V consists of section 197 intangible assets in the nature of goodwill and going concern value. The total allocable basis is first decreased by the amount of Class I assets. Any remaining amount is allocated proportionally to Class II assets to the extent of their fair market value. Any remaining amount is then allocated first to Class III assets and then to Class IV assets in the same manner as to Class II assets. Finally, any remaining amount is allocated to the Class V assets. See §§1.338(b)-2T and 1.1060-1T.

#### *Reasons for change*

##### *A. In General.*

The regulations under section 338 have developed, in large part, through a series of small changes and additions according to the priorities of taxpayers' and the government's needs and in response to statutory amendments to section 338 or other relevant Code sections. Most of the regulations under section 338 (§§1.338-1, 1.338-2, 1.338-3, 1.338-4, 1.338-5, 1.338(b)-1, 1.338(h)(10)-1, and 1.338(i)-

1) were made final as part of a single package as recently as 1994, but, with the exception of the consistency rules, most of those regulations were largely restatements of the existing temporary regulations that had been developed to that point. The remaining temporary regulations under section 338 and the temporary regulations under section 1060 have been substantively changed only once since 1986 and 1988, respectively, to accommodate the addition of section 197 to the Code. As a result of the ad hoc manner in which the regulations under sections 338 and 1060 have been amended, the current regulations are difficult to follow. Thus the IRS and Treasury determined that a review of the regulations was appropriate.

In addition, the current regulations have proven problematic in three major respects: first, in their statement of tax accounting rules and their relationship to tax accounting rules for asset purchases outside of section 338, second, in the effects of the allocation rules, and, third, in their lack of a statement of a complete model for the deemed asset sale (and, in the case of section 338(h)(10) elections, the deemed liquidation) from which one can determine the tax consequences not specifically set forth in the regulations.

##### *B. Tax Accounting Rules under Current Regulations.*

The current regulations include certain rules for accounting for items in connection with the deemed asset sale. These tax accounting rules apply for determining the original amounts of and subsequent adjustments to ADSP and AGUB. For example, the regulations provide rules governing the treatment of contingent liabilities deemed assumed by new target. In some respects the tax accounting rules in the current regulations differ considerably from the tax accounting rules applicable to actual asset sales.

##### *Link between old target's and new target's tax accounting*

Under the current regulations, ADSP is defined as the sum of (a) the grossed-up basis of the purchasing corporation's recently purchased target stock, (b) the liabilities of new target, and (c) other relevant items. Thus, the calculation of ADSP is linked to the tax accounting

treatment of new target or the purchaser of new target in item (a) above. Such link does not exist, however, in the case of an actual asset sale between two parties. In actual asset sales the timing and amount of the seller's amount realized and the timing and amount of the buyer's basis may differ. For example, with respect to the link under (a), the current fair market value of promised future contingent payments that constitute debt is taken into account in amount realized under §1.1001-1(g) unless, in rare and extraordinary circumstances, the fair market value is not reasonably ascertainable. Yet, under §1.1012-1(g), the current fair market value of such future contingent payments is not taken into account currently in the purchaser's basis.

This link between old target's deemed sales price and the purchasing corporation's basis in target stock existed in the original version of section 338, adopted in 1982. In 1984, Congress removed that link from the statute, providing instead that old target should be deemed to sell its assets at fair market value. The regulations originally allowed old target to choose between using the three-part formula (items (a) through (c)) above to calculate ADSP and treating the assets as being sold at their fair market value. In 1994, new regulations eliminated the election, thereafter requiring use of the three-part formula. Under the current regulations, any contingent payments for target stock do not become part of AGUB and ADSP until they become fixed and determinable. However, no rule prevents the seller from using all its basis to offset the amount realized in the year of the deemed sale. As a result of the link between old target's deemed sales price and the purchasing corporation's purchase price, old target receives open transaction treatment on terms broader than those available in an actual asset sale. Compare §15A.453-1(d)(2)(iii) ("Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation . . . cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open.'")

##### *Liabilities assumed*

The current regulations specify new target's tax accounting treatment for the

assumption of liabilities. New target takes a liability into account in AGUB only if it is a bona fide liability of target as of that date that would be properly taken into account in basis under principles of tax law if new target had acquired old target's assets from an unrelated person and, as part of the transaction, had assumed, or taken property subject to, the liabilities, and the amount thereof is determined on the same basis. §1.338(b)-1(f)(1) and (2).

Under §1.338(b)-3T(a)(1), AGUB is subsequently redetermined only if an adjustment would be required, under general principles of tax law, in connection with an actual asset purchase by new target from an unrelated person. One of the subsequent events enumerated as an example is the change in a contingent liability of target to one which is fixed and determinable. Section 1.338(b)-3T(c)(1) provides that a contingent amount (including contingent liabilities of old target deemed assumed) is taken into account at the time at which such amount becomes fixed and determinable. The statement of the latter rule suggests to some that it overrides the rules based on general principles of tax law stated in §§1.338(b)-1(f)(2) and 1.338(b)-3T(a)(1). However, interpreting the fixed and determinable rule in this manner would be inconsistent with the economic performance rules of section 461(h), that, in some circumstances, would operate to defer new target's taking an assumed liability into account until some time after the liability becomes fixed and determinable. See §§1.461-4(a) and 1.446-1(c)(1)(ii)(B).

#### *Installment method*

The current regulations provide no rules for old target to report its deemed sale gain under the installment method. Because the parties could have structured an actual asset sale to qualify for the installment method, commentators have argued that making the installment method available when a section 338(h)(10) election is made would be consistent with the full asset sale model implied by those rules. Making the installment method available when only a section 338(g) election is made would not be appropriate because the target shareholders are still treated as selling stock and because target would get a step-up in basis of assets be-

fore it had borne the tax burden for such step-up.

#### *C. Allocation Rules under Current Regulations.*

##### *Fast pay assets*

The current regulations employ a residual method of allocation. Under the residual method, the amount of basis to be allocated to goodwill and going concern value is based entirely on the amount of basis remaining to be allocated after all other assets have been allocated basis to the extent of their fair market values. Because assets other than goodwill and going concern value tend to be more easily valued, the residual allocation method is intended to result in less controversy over the value of goodwill and going concern value. The legislative history of section 1060, adopted in the Tax Reform Act of 1986, Public Law 99-514, (100 Stat. 2282), noted with approval the use of the residual method under the section 338(b) regulations and required that the same method be used in regulations to be prescribed under section 1060. See S. Rep. No. 313, 99th Cong., 2d Sess., May 29, 1986, at 254. Accordingly, the current regulations place each acquired asset into one of five asset classes. The total allocable basis is allocated among the classes starting with the first class and proceeding to the final, residual class. No asset in any class except for the residual class can be allocated more than its fair market value. If the aggregate basis allocable to a particular class is less than the aggregate fair market value of the assets within the class, each asset is allocated an amount in proportion to its fair market value and nothing is allocated to any junior class.

The residual allocation method presents unique problems when the cost of the assets, and hence the basis to be allocated thereto, is less than the aggregate fair market value of the individual assets. This situation may arise as a result of the use of contingent consideration for target stock or the deemed assumption of liabilities that are not yet taken into account. If this is the case, the basis of the assets is said to be impaired. Under the residual method, the impairment is borne equally by the assets in the first class in which the cumulative fair market value exceeds the remaining aggregate basis available for

allocation. As no basis is allocated to assets in junior classes, they are also impaired. If such an asset is sold, the taxpayer will realize a gain on its disposition even if its value has not increased since the acquisition date. Taxpayers may reverse the gain recognized in later years if the purchasing corporation pays or incurs additional amounts for target stock or additional target liabilities deemed assumed are taken into account. For this reason, the gain recognized is often referred to as phantom income.

The problem is most acute with assets that turn over quickly, such as accounts receivable and inventory (fast pay assets). Comments received on the temporary regulations suggested that fast pay assets should be placed in a more senior class to make it more likely that basis is allocated equal to the assets' fair market values in order to alleviate concerns over phantom income.

##### *Top-down allocation*

Under the current regulations, stock in a subsidiary is generally a Class III asset. In allocating basis among tiered corporations, an allocation to the stock of a subsidiary becomes the starting point for allocation to the assets inside the subsidiary if a section 338 election is also made for the subsidiary. See, e.g., §1.338-2(b)(4) of the current regulations. One might refer to this as top-down allocation. Under a top-down allocation, the basis of assets of a particular class can be more impaired at one corporate level than at another. For example, Class III assets in the parent target corporation might be allocated some basis while Class II assets in its subsidiary are allocated no basis because Class I assets in the subsidiary have absorbed all the basis allocated to the stock in the subsidiary, a Class III asset. The differences in impairment arising from the differences in the location of assets and liabilities is inconsistent with the residual method (e.g., liabilities secured by an asset support basis of all assets in a single corporation) and can lead to the misallocation of basis.

#### *D. Statement of Complete Model.*

For purposes of effectuating the statutory purpose of permitting taxpayers to elect to treat a stock acquisition as an

asset acquisition, section 338 and the current regulations deem certain transactions to occur. The current regulations' express statement of these deemed transactions provides the appropriate Federal income tax consequences for most targets for which a section 338 election is made. However, as with the tax accounting rules, some taxpayers interpret the express statements in the current regulations as resulting in tax consequences different from those had they actually engaged in the transactions deemed under the regulations to have occurred or as resulting in the tax consequences specifically stated and not any of the collateral consequences.

### *Explanation of Provisions*

#### *A. Overview of Changes.*

The proposed regulations are intended to clarify the treatment of, and provide consistent rules (where possible) for, both deemed and actual asset acquisitions under sections 338 and 1060. In addition, the proposed regulations propose changes to the current regulations to take into account changes to the tax law made since the different portions of the current regulations were published. The changes made by the proposed regulations have four major components: organization of the regulations; clarification and modification of the accounting rules applicable to deemed and actual asset acquisitions; modifications to the residual method mandated for allocating consideration and basis; and miscellaneous revisions to the current regulations. These changes are discussed in the order in which they arise in the proposed regulations. The IRS and Treasury did not address any provisions of the regulations relating to the consistency rules or the international aspects of section 338.

#### *B. Organization of Regulations.*

The proposed regulations change the organization of the regulations in order to make the rules for all asset acquisitions more administrable and provide consistent treatment, when appropriate, for deemed and actual asset acquisitions. In order to make the regulations more administrable, the proposed regulations redesignate certain of the final regulations

and reorganize and restate the remaining final and temporary regulations in a manner that is more consistent with the approach the IRS and Treasury has taken to drafting regulations in other areas. The proposed regulations also attempt to provide similar treatment, when appropriate, for deemed and actual asset acquisitions by stating the relevant concepts once in the regulations under section 338 and cross-referencing those rules in §1.1060-1 of the proposed regulations.

New §1.338-1 includes a scope statement. Section 1.338-1 also addresses the question of to what extent the deemed asset sale and other elements of the section 338 regime are considered as actually having occurred for purposes of application of other Code sections, such as those relating to retirement plan sponsors. Terminology and definitions and provisions regarding the mechanics of the section 338 election of current §1.338-1 have been moved to new §1.338-2. The return filing rules of current §1.338-1 have been moved to their own section, §1.338-10. All of the current §1.338-2 rules for qualification for making the section 338 election and rules relating to the effect on continuity of proprietary interest have been moved to new §1.338-3.

The rules defining ADSP, as well as various rules relating to taxation of old target, currently in §1.338-3, are in §1.338-4 of the proposed regulations. The rules defining AGUB, currently in §1.338(b)-1, are in §1.338-5. Current §1.338(b)-3T sets forth the timing of increases or decreases in ADSP and AGUB; these timing rules have been moved to new §1.338-4 (ADSP) and new §1.338-5 (AGUB).

Current §§1.338-4 and 1.338-5, dealing with consistency and with international aspects of section 338, respectively, have been renumbered §§1.338-8 and 1.338-9, respectively. The substance of these rules has not been addressed in connection with these proposed regulations.

Section 1.338-6 of the proposed regulations addresses allocation of ADSP and AGUB among assets, currently covered by §1.338(b)-2T. The rules pertaining to subsequent adjustments to ADSP and AGUB, currently in §1.338(b)-3T, are in §1.338-7 of the proposed regulations.

Section 1.338(h)(10)-1 has not been renumbered.

#### *C. §1.338-1 General principles; status of old target and new target.*

##### *Regulations' scope statement*

The scope statement describes the general model of the deemed asset sale and other aspects of the regulations used as the basis for the rules in the proposed regulations. This statement of the model should assist the reader generally in the correct interpretation and application of the regulations. This section also provides that old target and new target (as well as any other affected parties, for example, when a section 338(h)(10) election is made) are to determine the tax consequences as if they had actually engaged in the transactions deemed under the section 338 regulations to have occurred. Thus, the proposed regulations clarify that old target's deemed asset sale may result in tax consequences for old target and new target (such as income and deduction) in addition to old target's gain or loss realized on its deemed sale of assets. For example, if target is an insurance company for which a section 338 election is made, the deemed asset sale would be characterized and taxed as an assumption-reinsurance transaction under applicable Federal income tax law. See §1.817-4(d).

The proposed regulations make minor amendments to the list of sections in subtitle A for purposes of which old target and new target are considered the same corporation, notwithstanding the deemed asset sale between the two. Such changes generally are with respect to retirement plan and similar provisions.

##### *Anti-abuse rule*

The proposed regulations incorporate an anti-abuse rule giving the Commissioner, for purposes of calculating ADSP and AGUB and allocating ADSP and AGUB among assets, the authority under certain circumstances (a) to treat as not being part of target's assets those added to the pool of target's assets before the deemed asset sale and (b) to treat as being part of target's assets those removed from the pool of target's assets before the deemed asset sale. The Commissioner's authority to treat assets added to the pool as not being part of the pool exists when the property is transferred to old target in connection with the transactions resulting



in the application of the residual method if such property is, within 24 months after the deemed asset sale, (a) not owned by new target but owned, directly or indirectly, by a member of the affiliated group of which new target is a member, or (b) owned by new target but held or used to more than an insignificant extent in connection with an activity conducted, directly or indirectly, by another member of the affiliated group of which new target is a member in combination with other property acquired, directly or indirectly, from the transferor of the property to old target. The Commissioner's authority to treat assets removed from the pool as being part of the pool exists where the property is removed in connection with the transactions resulting in the application of the residual method if the removed property, within 24 months after the deemed asset sale, (a) is owned by new target, or (b) is owned, directly or indirectly, by a member of the affiliated group of which new target is a member and continues after the election to be held or used to more than an insignificant extent in connection with one or more of the activities of new target.

D. §1.338-2 *Nomenclature and definitions; mechanics of the section 338 election.*

*Definitions*

Four definitions of terms already used in the current regulations have been added to the proposed regulations under section 338. These terms are *acquisition date asset*, *deemed asset sale*, *deemed sale gain*, and *deemed sale return*. The scope of some of these terms has been expanded from their usage in the current regulations. For example, *deemed asset sale* refers to the transaction deemed under the section 338 regulations to occur between old target and new target and *deemed sale gain*, refers to, in the aggregate, the Federal income tax consequences (generally, the income, gain, deduction, and loss) of the deemed asset sale. Deemed sale gain can also refer to the Federal income tax consequences of the transfer of a particular individual asset in the deemed asset sale. The expanded definition of deemed sale gain in conjunction with the rules in §1.338-7(c) of the proposed regulations (§1.338(b)-3T(h) of the current regula-

tions) provides a mechanism for target (or, in the case of a section 338(h)(10) election, the member of the selling consolidated group, the selling affiliate, or the S corporation shareholders to which such income, loss, or other amount is attributable) to report items that are properly taken into account after the acquisition date. One such item would be the deduction for an assumed liability of old target that it could not deduct under its method of accounting on or before the acquisition date.

The definition of *purchasing corporation* has been clarified to include new target (new T) with respect to its deemed purchase of stock in its own subsidiary.

The definition of *selling group* in §1.338-2 of the proposed regulations and related provisions in §1.338(h)(10)-1 of the proposed regulations provide that a section 338(h)(10) election may be made for target notwithstanding that it was at some time during the year in which the acquisition date occurs the common parent of its affiliated or consolidated group, so long as it is not the common parent on the acquisition date.

E. §1.338-3 *Qualification for the section 338 election.*

*More than a nominal amount paid for purchase of stock*

The IRS and Treasury have received many informal comments in which guidance was requested on whether a section 338 election may be made for a target that is insolvent. In order to have a purchase of a share of stock in target, the proposed regulations generally require that more than a nominal amount of consideration be paid for the stock. With respect to target affiliates, one cannot adequately determine whether more than a nominal amount of consideration is paid for the stock because the amount paid is not determined in an arm's length transaction but instead under the allocation rules of the regulations. Consequently, the proposed regulations provide that stock in a target affiliate acquired by new target in the deemed asset sale of target's own assets is considered purchased if, under general principles of tax law, new target is considered to own stock of the target affiliate meeting the requirements of section 1504(a)(2), notwithstanding that no pur-

chase price may be allocated to target's stock in the target affiliate. For a discussion of the tax consequences when a qualified stock purchase is made of an insolvent corporation and a section 338(h)(10) election is made, see the discussion of section 338(h)(10) elections later in this preamble.

*Time for testing relationship*

A section 338 election may be made only with respect to a transaction that qualifies as a purchase within the meaning of section 338(h)(3). Under section 338(h)(3)(iii), the parties to the transaction must be unrelated in order for a transaction to qualify as a purchase. The statute is unclear, however, as to when the relationship between the parties is tested. The proposed regulation provides that the relationship is tested immediately after the transaction. This rule gives effect to the statutory objective of preventing a transferor from obtaining the benefits of a section 338 election while retaining a significant interest, directly or indirectly, in the property transferred. This rule also furthers the statutory objective of affording similar tax treatment to section 338 deemed asset sales and actual asset sales. For example, under this rule, if an actual sale of assets would qualify as a reorganization under section 368(a)(1)(D) (with a carryover of basis and other attributes), taxpayers are not able to reach a different result by structuring the transaction as a stock sale and electing under section 338.

F. §§1.338-4 and 1.338-5 *Aggregate deemed sale price; various aspects of taxation of the deemed asset sale; adjusted grossed-up basis.*

*Breaking the link between ADSP and AGUB*

Under the current regulations, the first element in the definition of ADSP is the grossed-up basis of the purchasing corporation's recently purchased target stock. The combination of the link between the definitions of ADSP and AGUB with the rule in the current regulations that contingent payments are taken into account in AGUB as they become fixed and determinable effectively affords old target open-transaction treatment, which treatment generally is inconsistent with



§§15A.453–1(d)(2)(iii) and 1.1001–1(g)-(2). The proposed regulations remove the link in the current regulations between calculation of the first element of ADSP and the purchaser's basis in recently purchased target stock.

The new first element in the calculation of ADSP is the grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock. Amount realized is determined as if old target itself were the selling shareholder. Also, notwithstanding that the sellers of the target shares may use the installment method of section 453 to report their gain on the stock, old target may not use the installment method in the calculation of the first element of ADSP.

#### *Time and amount combined*

The proposed regulations provide that general principles of tax law apply in determining the timing and amount of the elements of ADSP, and that ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, to the individual constituent elements of the definition of ADSP. The proposed regulations also provide a parallel rule for AGUB. Substantively, the two statements are designed to eliminate special accounting rules included in the current section 338 regulations—such as the current regulations' fixed and determinable rule for the timing of taking into account contingent amounts—and to bring taxation of old target's deemed asset sale closer to the taxation of an actual asset sale. In contrast to the current regulations, the proposed regulations state in one location all the rules for determining ADSP and AGUB.

Both the breaking of the link between the calculation of ADSP and the purchaser's basis in recently purchased stock and the removal of the fixed and determinable rule for contingent liabilities may often result in increased disparities between ADSP and AGUB.

#### *Liabilities*

The current regulations appear to presume that any tax liability of old target incurred on its deemed asset sale is a liability assumed by new target if a section 338(h)(10) election is not made but is not

a liability assumed by new target if a section 338(h)(10) election is made. These presumptions apparently required that the definition of ADSP be modified in current §1.338(h)(10)–1. The proposed regulations make clear that, whether or not a section 338(h)(10) election is made, old target's tax liability is deemed not assumed by new target only if the parties have agreed that (or the tax or non-tax rules operate such that) the seller, and not target, will bear the economic cost of that tax liability. This is because the legal burden for the tax would otherwise remain with target. Thus, the proposed regulations remove the term *MADSP* from §1.338(h)(10)–1, and extend the use of the term *ADSP* to that regulation.

Under the proposed regulations, the amount of liabilities of old target taken into account to calculate ADSP is determined as if old target had sold its assets to an unrelated person for consideration that included the unrelated person's assumption of, or taking subject to, the liabilities. Similarly, they provide that, in order to be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in basis under general principles of tax law that would apply if new target had acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liability. Regarding the timing of taking such liabilities into account, the proposed regulations provide that general principles of tax law apply in determining the timing and amount of the elements of ADSP and AGUB. Thus, for example, under general principles of tax law, a particular liability might not be taken into account in basis when a purchaser buys an asset subject to such liability, but might be taken into account at some later date; such timing controls the timing of including the liability in AGUB. Accordingly, the current rule in the regulations that liabilities are taken into account in calculating AGUB, and apparently ADSP, only when such liabilities become fixed and determinable is removed in the proposed regulations.

#### *Costs*

The treatment of selling costs for old target and acquisition costs for new target is modified. For old target, it is made clear that when grossing-up the selling

shareholders' amount realized where not all the target stock is recently purchased by the purchaser, the amount of selling costs by which that grossed-up amount realized is reduced is not itself grossed-up. For new target, the definition of AGUB is changed such that when the purchaser's basis in recently purchased stock is grossed-up, acquisition costs are no longer also grossed-up. Grossing-up the selling shareholders' selling costs or the purchasing corporation's acquisition costs would result in costs not actually incurred reducing old target's amount realized for the assets or increasing new target's cost basis in the assets. The IRS and Treasury do not believe that these results are appropriate because there is no evidence that the purchasing corporation's costs to acquire an amount of target stock sufficient for there to be a qualified stock purchase would increase proportionately if it acquired all of the target stock and the deemed asset sale mechanism allows taxpayers to avoid many of the costs that would be incurred in an actual asset sale. Accordingly, the IRS and Treasury have exercised the authority under section 338(b)(2) to prevent the grossing-up of selling costs and acquisitions costs.

#### *Other relevant items*

The element *other relevant items* is removed from the definitions of both ADSP and AGUB as it no longer serves any function. In the current regulations, this element reduces ADSP for the purchasing corporation's acquisition costs that would otherwise be taken into account because the purchaser's basis in recently purchased stock was an element in calculation of both ADSP and AGUB. This element becomes unnecessary with the removal of the link between ADSP and AGUB.

#### *G. §1.338–6 Allocation of ADSP and AGUB among target assets.*

##### *Allocation of ADSP and AGUB generally*

Apart from a change in the number of classes, the proposed regulations generally do not represent a substantive change in the system of allocation of ADSP and AGUB. The proposed regulation states the allocation rules that apply equally to ADSP and AGUB and then states the modifications to those common allocation rules for AGUB.

### *Transaction costs*

Generally, the definition of fair market value is the price at which a willing seller will transfer an asset to a willing buyer. Therefore, the fair market value of a particular asset to a seller is not different from the fair market value of the same asset to a buyer, even though the economic value of the asset to each would reflect the selling costs or acquisition costs. A seller may reduce its amount realized on an asset and a buyer may increase its cost basis in an asset for the transaction costs specifically allocable to the asset in an actual asset sale. Because the underlying transaction in section 338 is actually a stock sale, the costs incurred are not specifically allocable to any individual asset deemed transferred, but rather to the stock. Therefore, in applying the residual method to a deemed asset sale, transaction costs are accounted for only by decreasing the total amount realized by the seller or increasing the total cost basis of the buyer. In contrast, see the discussion of the treatment of transaction costs in an actual asset acquisition below.

### *IRS challenges to asset fair market value*

Drawing from the existing rules under section 1060, the proposed regulations provide that the IRS may challenge a taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties.

### *Number and content of classes*

The seven classes under the proposed regulations are as follows: Class I, cash and cash equivalents; Class II, actively traded personal property as defined in section 1092(d), certificates of deposit, and foreign currency; Class III, accounts receivable, mortgages, and credit card receivables which arise in the ordinary course of business; Class IV, stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; Class V, all assets not in Class I, II, III, VI, or VII; Class VI, all section 197 intangibles except goodwill

or going concern value; and Class VII, goodwill and going concern value.

### *AGUB less than the amount of Class I assets*

The proposed regulations clarify that, if the total AGUB (or consideration in an applicable asset acquisition under section 1060) to be allocated is less than the amount of Class I assets (i.e., cash and cash equivalents), then new target (or the purchaser in an applicable asset acquisition under section 1060) immediately recognizes ordinary income to that extent.

### *Marketable securities*

The current regulations include marketable stock and securities, as defined in §1.351-1(c)(3), in Class II. Marketable stock and securities are included in Class II because a value can be easily assigned at any given time by looking at the value at which those instruments were trading on a securities exchange. Since the time Class II was first defined, financial markets have evolved and a greater variety of financial instruments can be readily valued in the same manner. The proposed regulations instead defines Class II with respect to actively traded personal property as defined under section 1092(d) because the regulations under that section have a more comprehensive definition of public financial markets.

### *Fast pay assets*

The IRS and Treasury are aware that many taxpayers engage in transactions solely to avoid the impairment problems with fast-pay assets. In addition, the IRS spends time evaluating whether such transactions are subject to challenge under the section 338 regulations or general principles of tax law. In order to address these concerns, the proposed regulations create two new classes of assets between current Classes II and III, one for accounts receivable, mortgages, and credit card receivables which arise in the ordinary course of business and another for stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

### *Residual class*

In the current regulations, Class V, the residual class, is comprised of section 197 intangibles in the nature of goodwill and going concern value. Class IV is comprised of all section 197 intangibles except those in the nature of goodwill and going concern value. Because many section 197 intangibles would have been characterized by the IRS as assets in the nature of goodwill and going concern value prior to the enactment of section 197, the current regulations provide somewhat ambiguous guidance as to the line between current Class IV and current Class V. Accordingly, the proposed regulations remove the phrase "in the nature of." Furthermore, in rare circumstances, goodwill or going concern value is not a section 197 intangible. The residual class should include all goodwill and going concern value to ensure that the residual method serves the purpose of reducing valuation controversies. Therefore, the proposed regulations define the residual class as goodwill and going concern value without any reference to whether those assets would qualify as section 197 assets.

In T.D. 8711, *supra*, the IRS amended the current regulations to adapt the residual method to section 197 by creating a new Class IV for section 197 intangibles other than goodwill or going concern value and providing that goodwill and going concern value would remain in a true residual class. The proposed regulations retain this distinction in renumbered Class VI and Class VII. Allocating goodwill and going concern value to Class VII avoids the need for determining the value of goodwill and going concern value through a non-residual method.

### *Allocation of AGUB when gain recognition election available but not made*

When the purchaser of the target stock holds nonrecently purchased target stock and no section 338(h)(10) election is made, the purchaser has the option of making or not making the gain recognition election. (If a section 338(h)(10) election is made, the making of the gain recognition election is automatic rather than elective.) The proposed regulations retain these rules. The current regulations have a special allocation rule when the

failure to make the gain recognition election leaves AGUB less than ADSP (that is, when the purchaser's nonrecently purchased stock was bought at a lower price than the recently purchased stock). Under the special allocation rule, AGUB, after reduction by the amount of Class I assets, is allocated among all other assets, regardless of their class, in proportion to their fair market values. (For this purpose, the fair market value of assets in the residual class (current Class V) is deemed to be the excess, if any, of the hypothetical purchase price over the sum of the Class I assets and the fair market values of the Class II, III, and IV assets. The hypothetical purchase price is the AGUB that would result if a gain recognition election were made.)

If, looking at the hypothetical purchase price, full fair market value was paid on the acquisition date for assets in each class above the residual class, the current regulation's special allocation rule spreads the impairment that arises because no gain recognition election was made equally among all assets in classes below Class I. However, if, looking at the hypothetical purchase price, full fair market value was not paid on the acquisition date for assets in each class above the residual class, this rule spreads the impairment that arises because no gain recognition election was made as well as the impairment that arises from the bargain purchase equally among all assets in classes below Class I. In the latter case, the prioritization of classes under the residual method becomes irrelevant by the failure to make a gain recognition election. Prior to the enactment of section 197, the effect of the current regulations generally would have been to shift basis from depreciable or amortizable assets to nondepreciable, nonamortizable assets.

The proposed regulations modify the special allocation rule to minimize this effect. Generally, under the modified special allocation rule, the portion of AGUB (after reduction by the amount of Class I assets) to be allocated to each Class II, III, IV, V, VI, and VII asset is determined by multiplying (a) the amount that would be allocated to such asset under the general rules for allocation of AGUB were AGUB increased to equal the hypothetical purchase price by (b) a fraction, the numerator of which is actual AGUB (after reduc-

tion by the amount of Class I assets) and the denominator of which is the hypothetical purchase price (after reduction by the amount of Class I assets). The reason for the modification is to spread only the impairment that arises because no gain recognition election was made equally among all assets in classes below Class I.

The IRS and Treasury request comments as to whether any special allocation rule has continuing merit.

#### H. §1.338-7 Allocation of redetermined ADSP and AGUB among target assets.

##### *In general*

Section 1.338(b)-3T of the current regulations addresses subsequent adjustments to ADSP and AGUB. In the proposed regulations, these rules, contained in §1.338-7, have been streamlined and some of their content has been moved to the sections defining ADSP and AGUB, §§1.338-4 and 1.338-5 respectively. The proposed regulations eliminate the use of the term *adjustment event* used in certain provisions of the current regulations. Instead, the proposed regulations provide simply that when general principles of tax law require a change in the amount of any of the various elements of ADSP or AGUB (discussed earlier), the new ADSP or AGUB amount is reapplied to produce new allocations to the assets. This generally is not intended as a substantive change to the current rules for subsequent adjustments provided in §1.338(b)-3T.

##### *Item-specific adjustments*

The current regulations at §1.338(b)-3T contain special rules for changes to AGUB (and thus, indirectly, to ADSP) that relate to the income produced by intangible assets. The special rules apply for purposes of allocating an increase or decrease in AGUB or ADSP to the extent (a) the contingency that results in the increase or decrease directly relates to income produced by a particular intangible asset (contingent income asset) and (b) the increase or decrease is related to such contingent income asset and not to other target assets. The special rules consist of two provisions that vary from the normal rules of §1.338(b)-3T. Under the first provision, the fair market value of the

contingent income asset at the beginning of the day after the acquisition date is redetermined at the time of the increase or decrease in AGUB or ADSP (but only those circumstances that resulted in the increase or decrease to AGUB or ADSP are taken into account in the redetermination). Under the second, the increase or decrease in AGUB or ADSP is allocated first to the contingent income asset, not to all assets generally under the normal allocation rules. Any portion that cannot be so allocated because of the fair market value limitation (as redetermined) is allocated under the normal allocation rules.

The intent of this rule was to accommodate the uncertainties in the valuation of contingent income assets. The rule produces an allocation that would have resulted if the parties had known on the acquisition date the fair market value of the contingent income asset (as determined, with hindsight, on the date of the adjustment event) and paid on the acquisition date the increased or decreased consideration. The IRS and Treasury weighed the usefulness of this rule with its complexity and decided that the proposed regulations should not include any item-specific adjustment rule. Commentators, if they believe that the item-specific adjustment rule continues to serve a useful function that justifies its retention, should identify in their comments in what circumstances the rule has proven useful or could prove useful. Commentators should also identify what provisions would be necessary for an effective item-specific adjustment rule.

#### I. §1.338(h)(10)-1 Deemed asset sale and liquidation.

##### *Model*

The proposed regulations explain the effects of the section 338(h)(10) election on the parties involved. The proposed regulations discuss the effects of the section 338(h)(10) election on the purchasing corporation, the effects on new target, the effects on old target, and the effects on old target's shareholders (including non-selling shareholders).

As with the rest of the proposed regulations, proposed §1.338(h)(10)-1 describes the model on which taxation of the section 338(h)(10) election is based. Under the proposed regulations, old target



is treated as transferring all of its assets by sale to an unrelated person. Old target recognizes the deemed sale gain while a member of the selling consolidated group, or owned by the selling affiliate, or owned by the S corporation shareholders (both those who actually sell their shares and any who do not). Old target is then treated as transferring all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and ceasing to exist. If target is an S corporation, the deemed asset sale and deemed liquidation are considered as occurring while it is still an S corporation. The proposed regulations treat all parties concerned as if the fictions the section 338(h)(10) regulations deem to occur actually did occur, or as closely thereto as possible. The structure of this model should help taxpayers answer any questions not explicitly addressed by the proposed regulations. Also, old target generally is barred by the proposed regulations from obtaining any tax benefit from the section 338(h)(10) election that it would not obtain if it actually sold its assets and liquidated.

The treatment of S corporation targets which own one or more qualified subchapter S subsidiaries (as defined in section 1361(b)(3)) is also addressed, as is the treatment of tiered targets (i.e., the order of their deemed asset sales and deemed liquidations).

#### *Deemed liquidation*

The current regulations provide that, when a section 338(h)(10) election is made, old target is deemed to sell all of its assets and distribute the proceeds in complete liquidation. The term *complete liquidation* is generally considered to be a term of art in tax law. The proposed regulations instead provide that old target transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and ceased to exist, making it clear that the transaction following the deemed asset sale does not automatically qualify as a distribution in complete liquidation under either section 331 or 332. This is meant to clarify any inference one might draw from previous regulations that section 332 treatment is automatic under section 338(h)(10) in the case of an affiliated or consolidated group. For example, if S

owns all of the stock of T, T is insolvent because of its indebtedness to S, P acquires T from S in a qualified stock purchase, and, as a condition of the sale, S cancels the debt owed it by T, and P and S make a section 338(h)(10) election for target, T's deemed liquidation would not qualify under section 332 because S would not be considered to receive anything in return for its stock in T. Rev. Rul. 68-602 (1968-2 C.B. 135).

#### *Special S corporation issues*

The current regulations provide that, notwithstanding the purchase of 80 percent of the shares of an S corporation by a purchasing C corporation, the S corporation continues to be considered an S corporation for purposes of determining the tax effects of the section 338(h)(10) election to old target and its S corporation shareholders. For example, old target reports to its shareholders under section 1366 the tax effects of its deemed asset sale, and the shareholders adjust their stock basis pursuant to section 1367. The proposed regulations clarify that when the target itself is an S corporation immediately before the acquisition date, any direct and indirect subsidiaries of target with respect to which qualified subchapter S subsidiary elections are in effect are considered to remain qualified subchapter S subsidiaries for purposes of target's and its S corporation shareholders' reporting the effects of target's deemed sale of assets and deemed liquidation. No similar rule applies when a qualified subchapter S subsidiary, as opposed to the S corporation that is its owner, is the target corporation. The IRS and Treasury request comments as to whether it would be beneficial to make section 338(h)(10) elections available for acquisitions of qualified subchapter S subsidiaries and as to how the section 338(h)(10) regulations should be modified to accommodate the unique taxation of these entities.

The proposed regulations clarify the effects of the section 338(h)(10) election on both selling and non-selling S corporation shareholders. For example, the proposed regulations clarify that all S corporation shareholders, selling or not, must consent to the making of the section 338(h)(10) election, particularly because the non-selling shareholders have to include their proportionate share of the deemed sale

gain under section 1366. Form 8023 will be corrected to reflect this requirement.

#### *Availability of the section 453 installment method*

When some or all of the target stock is purchased for an installment obligation and a section 338(h)(10) election is made, the proposed regulations make the section 453 installment method available to old target in its deemed asset sale, as long as the deemed asset sale would otherwise qualify for installment sale reporting. Solely for purposes of the application of section 453 and related provisions to the deemed asset sale and subsequent deemed corporate liquidation under section 338(h)(10), old target generally is considered to receive from new target in the deemed asset sale consideration consisting of the installment obligation given to old target shareholders in exchange for recently purchased stock, the assumption of, or taking subject to, old target liabilities, and cash. Thus, regardless of its actual character, any consideration conveyed by the purchaser to the selling shareholders other than installment obligations is considered to have been in cash, including for instance the purchaser's assumption of, or taking subject to, liabilities of the selling shareholders. In addition, the amount of any grossing-up under §1.338-4(d) of the proposed regulations is deemed to be in the form of cash. For purposes of section 453, new target is considered to be the obligor on the installment obligation the purchasing corporation actually issued. The provisions of sections 453(h), 453B(d), and 453B(h) may then apply to old target and its shareholders with respect to the deemed liquidation of old target following the deemed asset sale. In the deemed liquidation, a selling shareholder who actually received an installment obligation in the stock sale is deemed to receive that installment obligation as part of the liquidating distribution; the other shareholders are deemed to receive none of the installment obligation.

The proposed regulations provide that old target generally is barred from obtaining any tax benefit from the section 338(h)(10) election that it would not obtain if it actually sold its assets and liquidated. This bar extends to the application of section 453. In other words, the results of application of section 453 to old target



should be as close as possible to those that would occur if old target actually sold its assets for an installment obligation of the purchaser. Thus, for example, the installment method of section 453 applies unless old target affirmatively elects out of the installment method.

As another example, §15A.453-1(b)-(2)(iv) provides that any obligation created subsequent to the taxpayer's acquisition of the property and incurred or assumed by the taxpayer or placed as an encumbrance on the property in contemplation of disposition of the property is not qualifying indebtedness if the arrangement results in accelerating recovery of the taxpayer's basis in the installment sale. Old target would be subject to this test with respect to its debts new target is deemed to assume or take subject to.

Further, the rule of section 453A requiring payment of interest will apply in the same manner as it would apply if target actually sold all its assets in return for consideration that included an installment obligation from the purchaser and then distributed in complete liquidation all the consideration received.

#### *Tiered targets*

The proposed regulations provide that, in the case of parent-subsidiary chains of corporations making section 338(h)(10) elections, the deemed asset sale at the parent level is considered to precede that at the subsidiary level. The proposed regulations then provide, however, that the deemed liquidation of the subsidiary is considered to precede the deemed liquidation of the parent.

#### *Additional information required*

The proposed regulations provide that the Commissioner may exercise the authority granted in section 338(h)(10)-(C)(iii) to require the provision of any information deemed necessary to carry out the provisions of section 338(h)(10) by requiring submission of information on any tax reporting form. The IRS and Treasury are considering requiring that the information about the amount and allocation of AGUB and ADSP currently submitted on the election form (Form 8023) instead be submitted by the purchaser and seller(s) separately on their income tax returns, and is interested in comments on this approach.

#### *J. §1.1060-1.*

##### *Definition of trade or business*

Section 1060 applies to the direct or indirect transfer of a trade or business. Under the current regulations, a group of assets constitutes a trade or business if the use of such assets would constitute an active trade or business for purposes of section 355. Further, even if a group of assets would not qualify as an active trade or business for purposes of section 355, a group of assets will constitute a trade or business for purposes of section 1060 if goodwill or going concern value could attach under any circumstances. The current regulations set out factors that will be considered in determining whether goodwill or going concern value could attach.

Although the current regulations set out factors, there are still ambiguities regarding when goodwill or going concern value could attach. For example, §1.1060-1T(b)(2) has been misinterpreted to mean that a trade or business exists only when basis is allocated to goodwill or going concern value under the residual method. Under the misinterpretation, a taxpayer would be required to filter every bulk asset purchase through the residual allocation method in order to determine whether the transaction is subject to section 1060. The proposed regulations clarify that a trade or business is present if goodwill or going concern value could attach to the group of assets, regardless of whether any value will eventually be allocated to the residual class (Class VII).

In addition, the proposed regulations provide that the presence of assets in the nature of section 197 assets is a factor to be considered in determining whether goodwill or going concern value could attach. This clarification recognizes that many section 197 assets would have been considered part of goodwill or going concern value at the time Congress enacted section 1060. However, the proposed regulations make it clear that the transfer of an isolated section 197 asset will not be subject to section 1060.

The proposed regulations clarify that an applicable asset acquisition can occur even if the trade or business is transferred from seller to purchaser in a series of related transactions and that the residual method must be applied once to all of the assets transferred in a series of related

transactions. The proposed regulations also incorporate the principles of the anti-abuse rule from §1.338-1(c) of the proposed regulations to determine which assets must be included for purposes of applying the residual method.

##### *Asymmetrical transfers of assets*

Section 1060 applies to the direct or indirect acquisition of a trade or business when the purchaser's basis in the assets (other than assets to which section 1031 applies) is determined wholly by reference to the consideration paid by the purchaser. This rule clarifies that a purchaser of assets in an applicable asset acquisition is subject to the allocation rules set out in §§1.338-6 and 1.338-7 even if the transferor in the transaction is treated as transferring something different from the assets the transferee is treated as receiving. For example, Rev. Rul. 99-6 (1999-6 I.R.B. 6) concerns the purchase, by one person, of all of the interests in a limited liability company which is classified as a partnership under §301.7701-3. The revenue ruling sets forth two situations and holds that each seller is treated as having transferred its interests in the partnership, while each purchaser is treated as having purchased the assets of the limited liability company. The proposed regulations make it clear that each purchaser described in Rev. Rul. 99-6 must use the residual method prescribed under §§1.338-6 and 1.338-7 to allocate the consideration paid for the purchased assets (provided that the asset transfer otherwise qualifies as an applicable asset acquisition).

##### *Multiple trades or businesses transferred in a single transaction*

The current regulations are silent on the proper application of the residual method to situations when a seller transfers a group of assets that could be categorized as constituting more than one trade or business. The proposed regulations clarify that, as long as any part of the assets are a trade or business, all of the assets are to be treated as a single trade or business for purposes of applying the residual method. Therefore, the residual method should be applied once to all of the assets transferred, rather than to blocks of the assets separately. This rule is intended to reduce valuation conflicts regarding how

much consideration should be allocated to each separate group of assets. By treating all of the assets as a single trade or business, all assets in Classes I through VI can receive full fair market value allocation before the goodwill of any trade or business is allocated basis. In addition, this rule brings actual asset acquisitions into conformity with deemed asset acquisitions by allocating consideration paid across all assets acquired, without looking to the trade or business with which they are associated.

#### *Miscellaneous changes*

The proposed regulations incorporate two miscellaneous changes addressing issues that have arisen under the current regulations. First, the proposed regulations include any covenants entered into between the seller and the purchaser in connection with an applicable asset acquisition as an asset transferred as part of a trade or business even though, to the seller, the covenant is a contract for services. As a result, sellers must include any covenants in the asset pool for purposes of applying the residual method, thus allowing for greater symmetry to be achieved between the purchaser and seller.

Second, the like-kind exchange rule in the current regulation has been expanded. Under this expanded rule, if an applicable asset acquisition includes property that is transferred subject to any provision of the Code or regulations that has the tax effect of section 1031, the tax treatment determined under such provision is given effect. The residual method is then applied to the remaining assets and consideration exchanged.

In addition, the proposed regulations no longer separately state the residual allocation method. Instead, proposed §1.1060-1 incorporates the residual method by cross reference to proposed regulations §§1.338-6 and 1.338-7. Proposed regulation §1.1060-1 only sets out rules in which the treatment of an actual asset acquisition differs from the treatment of a deemed asset acquisition. By cross-referencing the section 338 regulations rather than separately stating the residual method, the proposed regulations ensure that deemed and actual asset acquisitions will be treated similarly to the extent possible.

#### *Transaction costs*

Under the current regulations, consideration is allocated to each asset to the extent of that asset's fair market value as long as there is sufficient consideration to provide full allocation of basis to each asset in the class. The fair market value limitation and the residual allocation method of the current regulations do not permit costs associated with specific assets to be allocated to those assets. For example, if a purchaser incurred costs to acquire an asset and section 1060 did not apply to the acquisition, the basis of that asset would be increased to reflect those costs. However, the fair market value limitation under the current regulations would limit a purchaser's basis in the asset to its fair market value. The proposed regulations allow the buyer and seller to adjust their allocation of consideration to particular assets for costs incurred which are specifically identified with those assets. Thus, the total amount the seller allocates to an asset for which it incurs specifically identifiable costs would be less than its fair market value and, for the buyer, greater than its fair market value. The parties are not allowed to apportion costs associated generally with the overall transaction to specific assets. A similar rule is not necessary, and therefore not included, under section 338, because the underlying transaction is a stock sale. Any costs associated with a deemed asset sale are of the type generally associated with the overall sale of stock and, therefore, the parties would not be allowed to apportion those costs to specific assets under the rule.

#### *Written allocation agreements*

After the current regulations were adopted, Congress amended section 1060 to provide that a written agreement allocating purchase price is binding on both parties. See section 1060(a). The legislative history indicates that parties must report consistent with their agreed-upon allocations, unless the parties are able to refute the agreement under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967). The proposed regulations incorporate the Danielson standard by reference.

#### **Specific requests for comments and matters under study**

##### *A. Examples in the Section 338 and Section 1060 Regulations.*

The proposed regulations, for the most part, retain the examples of the current regulations. The retained examples are updated to reflect the changes in the location, terminology, and substance of the regulations which they illustrate. Some examples have been dropped as it was thought that they were unnecessary. Comments are requested as to whether any of the retained examples (or new examples) are superfluous and whether other examples are necessary to illustrate the regulations.

##### *B. Discharge of Indebtedness Income in the Case of Tiered Targets under Section 338 and the Current Regulations.*

Taxpayers may inadvertently experience adverse tax consequences when there is intercompany indebtedness owing between tiered targets acquired in the same qualified stock purchase. Such consequences might include the realization of discharge of indebtedness income and changes to the issue price of the indebtedness. The latter could affect the total amount of AGUB to be allocated.

For example, assume that T owns 100 percent of the stock of T1, T and T1 do not file a consolidated return, and T is indebted to T1. Assume also that P acquires all the stock of T in a qualified stock purchase and makes section 338 elections for both T and T1. Under §1.338-2(b)(4), first old T is considered to sell its assets to new T, and new T is deemed to assume the debt of old T to old T1. Next, old T1 is deemed to sell its assets to new T1. New T1 thus may be considered to acquire debt owed by new T (to old T1) at a time when new T1 is related to new T.

Under section 108(e)(4), this may trigger discharge of indebtedness income for new T if new T1's adjusted basis in the acquired debt is less than the amount of the debt (see §1.108-2(f)(1)). That might occur when the T stock is purchased partly for contingent consideration not originally taken into account in AGUB. A variety of similar issues may arise under §1.1502-13(g).

The IRS and Treasury solicit comments on whether the application of section 108(e)(4) and §1.1502-13(g) is appropriate in these circumstances and how one might best address these consequences.

*C. Ideas for Revision of Application of the Residual Method of Allocation under Section 338 in the Case of Tiered Targets.*

*In general*

The IRS and Treasury are studying ways of addressing the allocation of ADSP and AGUB in the case of tiered targets making section 338 elections. Set forth below is the framework for one potential method that would equalize the amount of impairment for assets in a given class without regard to which target corporation owns the assets. This method uses a lookthrough approach. The method is incomplete, raises difficult issues, and is more complicated than the current rules. For these reasons, the proposed regulations do not adopt the method. However, the IRS and Treasury request comments as to the value and feasibility of the method; how best to resolve its issues; and what alternative approaches might be better. For instance, would it be better to have a complicated special method such as that described below that operates in every case of tiered targets or, as the proposed regulations do, retain the approach of the current regulations with the addition of an anti-abuse rule, the goal of which is to restrict movement of assets in advance of the qualified stock purchase undertaken to benefit from the shortcomings of the current top-down rules?

Essentially, the lookthrough approach referred to above would revise the treatment of Classes I through V (referring to the class numbering system of the proposed regulations). In allocating to these senior classes, the tiered targets would be aggregated for purposes of calculating the overall purchase price and allocating that amount among the individual assets. This rule would apply to a target (referred to as the parent target) and to those of its lower tier subsidiaries for which a section 338 election is also made (referred to as subsidiary targets). Stock in subsidiaries for which section 338 elections are not or cannot be made would continue to be

treated for all purposes as a Class V asset (or Class II if publicly traded)—in other words, such entities would not participate in the aggregation.

The method would thereafter switch back to the normal top-down system for allocation to assets in Classes VI and VII, because the process of dividing up the amount allocated to the aggregate goodwill of all the targets under the residual method would be antithetical to the notion that goodwill is best valued by looking at what value is left over rather than being separately valued, and because both Class VI and VII assets generally get the same 15 year amortization period pursuant to section 197—hence determining which of those two classes or assets within the classes receives a given dollar of basis is relatively insignificant.

An issue in applying the method is how to treat liabilities owed by one group member to another. The IRS and Treasury request comments as to whether such liabilities should be treated for all allocation purposes as not debt but as stock in the debtor-member held by the creditor-member, and whether to do so even if the creditor-member is a subsidiary of the debtor-member.

One possible method of implementing the method is set forth in greater detail, below.

Possible method of implementation of the lookthrough approach

The first step under the method would be to calculate the total amount to be allocated (ADSP and AGUB). Under the method, this would be the sum of (a) the amount realized or basis, as appropriate, of the parent target stock (grossed-up as appropriate to reflect stock not recently purchased, etc.) and (b) liabilities.

In the second step, all Class I through Class V assets in the parent target and subsidiary targets (other than stock of subsidiary targets) would be combined into aggregate Classes I, II, III, IV, and V. Then, the total basis would be allocated (as basis is under the current system, except that the allocation would be across such joint classes, not merely within individual members) first to Class I assets, then, if there is any remainder, to Class II assets, then, if there is any remainder, to Class III assets, then, if there is any re-

mainder, to Class IV assets, and then, if there is any remainder, to Class V assets. The allocations thus made to individual Class I through V assets would be the final, binding allocations to them.

In the third step, if there were no amount of the total basis remaining to be allocated to Class VI and VII assets, one would proceed to determine the basis in subsidiary target stock. If the aggregate amount assigned to all the subsidiary's Class I through V assets pursuant to the second step above exceeded the amount of the subsidiary's liabilities, then the amount of the excess would become its parent's basis in that subsidiary's stock.

If the aggregate amount were, however, less than the liabilities, then the stock basis would be zero. A subissue is whether in such case other action should also be taken: whether, in the case of a consolidated group, an excess loss account should be created equal to the amount of the shortfall; and whether, if the tiered entities do not join in filing a consolidated return but other nonconsolidated investment adjustment rules apply, future positive basis increases should be denied to the extent of the excess loss account that would have been created under the method had they been filing consolidated. The rule could apply, for example, to increases in basis of controlled foreign corporations for undistributed earnings taxed currently under subpart F.

Under the method, if there were an amount of the total ADSP or AGUB remaining to be allocated to Class VI and VII assets, then one would proceed to allocate basis to Class VI and VII assets. At this point, the aggregating of members' assets into joint classes would be abandoned and the method would revert to a top-down system similar to that of current rules. The process is top-down in that any basis not already allocated to the parent target's Class I through V assets (other than subsidiary target stock) would be allocated among its Class VI and VII assets and subsidiary target stock, then the subsidiary target would in turn make its own allocation of its own basis among its own Class VI and VII assets and any stock it might own in other subsidiary targets.

Certain adjustments, as yet undetermined, would have to be made to this method for minority interests outstanding in subsidiaries.



## Possible disadvantages of the method

The method has drawbacks:

(1) *Complexity.* The method is more complicated than the existing rules. When, for example, there is a subsequent change in the amount of a liability of a subsidiary target that changes the amount of AGUB or ADSP, under the method one would recalculate the allocations to all the assets of the parent target and all subsidiary targets, not just the assets of the indebted subsidiary target and its own subsidiary targets.

Also, questions arise regarding subsequent changes in AGUB and ADSP, with respect to subsidiary targets already disposed of. What if, for instance, at the time of a subsequent adjustment to AGUB or ADSP, the group had already disposed of the stock of a particular subsidiary target—should one change the allocation to that former subsidiary's assets? Separately, in determining whether AGUB or ADSP has changed, should one take into account changes in the amount of liabilities of former subsidiary targets? How would the group be made aware of such changes?

(2) *Lack of inside-outside basis conformity.* The current system, although it tolerates large disparities in the allocations to identical assets based on location, assures conformity between stock basis and net asset basis. The look-through approach does so only in a consolidated setting (employing excess loss accounts to do so).

(3) *The method would not eliminate all allocation disparities.* The method would not completely eliminate disparate allocations based on location within the acquired group, because it applies only to tiered targets. Similar disparities can exist in acquisitions of sister corporations or in mixed stock and asset purchases. The method does not include a mechanism for equalizing basis impairment in such cases. Thus, the method would not fully solve the disparity problem. (Note, however, that the new anti-abuse rule included in the proposed regulations may operate in some cases.)

## Proposed Effective Date

The regulations are proposed to be effective on the date that final regulations are published in the **Federal Register** and

apply to qualified stock purchases or applicable asset acquisitions occurring on or after the date that final regulations are published in the **Federal Register**.

## Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. An initial regulatory flexibility analysis has been prepared pursuant to 5 U.S.C. section 604 for the collections of information in this Treasury Decision. The analysis is set forth below under the heading "Initial Regulatory Flexibility Analysis." Pursuant to section 7805(f) of the Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Initial Regulatory Flexibility Analysis

This regulatory action is intended to simplify and clarify the current rules relating to both deemed and actual asset acquisitions. The current rules were developed over a long period of time and have been repeatedly amended. The IRS and Treasury believe these proposed regulations will significantly improve the clarity of the rules relating to both deemed and actual asset acquisitions.

The major objective of the proposed regulations is to modify the rules for allocating purchase price in both deemed and actual asset acquisitions. In addition, the proposed regulations replace the general rules for electing to treat a stock sale as an asset sale.

These collections of information may affect small businesses if the stock of a corporation which is a small entity is acquired in a qualified stock purchase or if a trade or business which is also a small business is transferred in a taxable transaction. Form 8023 (on which an election to treat a stock sale as an asset sale is filed) has been submitted to and approved by the Office of Management and Budget. With respect to Form 8023, the IRS estimated that 201 forms would be filed each year and that each taxpayer would require 12.98 hours to comply. Form 8594 (on which a sale or acquisition of assets constituting a trade or business is reported)

has also been submitted to and approved by the Office of Management and Budget. With respect to Form 8594, the IRS estimated that 20,000 forms would be filed each year and that each taxpayer would require 12.25 hours to comply. These estimates have been made available for public comment and no public comments have been received. These proposed regulations do not impose new requirements on small businesses and, in fact, should lessen any difficulties associated with the existing reporting requirements by clarifying the rules associated with deemed and actual asset acquisitions.

The collections of information require taxpayers to file an election in order to treat a stock sale as an asset sale. In addition, taxpayers must file a statement regarding the amount of consideration allocated to each class of assets under the residual method. The professional skills that would be necessary to make the election or allocate the consideration would be the same as those required to prepare a return for the small business.

Consideration was given to limiting the reporting requirements under section 1060 to trades or businesses meeting a threshold level of business activity. However, any threshold derived without further information would be arbitrary. Instead, the proposed regulations authorize the Commissioner to exclude certain transactions from the reporting requirements.

## Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. The IRS and Treasury request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 12, 1999, beginning at 10 a.m. in the NYU Classroom, Room 2615, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identifica-

tion to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The IRS recognizes that persons outside the Washington, DC, area may also wish to testify at the public hearing through teleconferencing. Requests to include teleconferencing sites must be received by September 20, 1999. If the IRS receives sufficient indications of interest to warrant teleconferencing to a particular city, and if the IRS has teleconferencing facilities available in that city on the date the public hearing is to be scheduled, the IRS will try to accommodate the requests. The IRS will publish the locations of any teleconferencing sites in an announcement in the **Federal Register**.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must request to speak, and submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by September 20, 1999. A period of ten minutes will be allocated to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### *Drafting Information*

The principal authors of these proposed regulations are Richard Starke and Stephen R. Wegener, Office of the Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

#### *Proposed Amendments to the Regulations*

Accordingly, 26 CFR parts 1 and 602 are proposed to be amended as follows:

#### **PART 1—INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by removing the entries

for 1.338(b)–1, 1.338(b)–3T, and 1.1060–1T and by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.338–6 also issued under 26 U.S.C. 337(d), 338, and 1502.

Section 1.338–7 also issued under 26 U.S.C. 337(d), 338, and 1502.

Section 1.338–8 also issued under 26 U.S.C. 337(d), 338, and 1502.

Section 1.338–9 also issued under 26 U.S.C. 337(d), 338, and 1502.

Section 1.338–10 also issued under 26 U.S.C. 337(d), 338, and 1502.\* \* \*

Section 1.1060–1 also issued under 26 U.S.C. 1060.\* \* \*

Par. 2. Sections 1.338–0 through 1.338–3 are revised to read as follows:

#### *§1.338–0 Outline of topics.*

This section lists the captions contained in the regulations under section 338 as follows:

#### *§1.338–1 General principles; status of old target and new target.*

- (a) In general.
  - (1) Deemed transaction.
  - (2) Application of other rules of law.
  - (3) Overview.
- (b) Treatment of target under other provisions of the Internal Revenue Code.
  - (1) General rule for subtitle A.
  - (2) Exceptions for subtitle A.
  - (3) General rule for other provisions of the Internal Revenue Code.
- (c) Anti-abuse rule.
  - (1) In general.
  - (2) Examples.

#### *§1.338–2 Nomenclature and definitions; mechanics of the section 338 election.*

- (a) Scope.
- (b) Nomenclature.
- (c) Definitions.
  - (1) Acquisition date.
  - (2) Acquisition date assets.
  - (3) Affiliated group.
  - (4) Common parent.
  - (5) Consistency period.
  - (6) Deemed asset sale.
  - (7) Deemed sale gain.
  - (8) Deemed sale return.
  - (9) Domestic corporation.
  - (10) Old target's final return.
  - (11) Purchasing corporation.

- (12) Qualified stock purchase.
- (13) Related persons.
- (14) Section 338 election.
- (15) Section 338(h)(10) election.
- (16) Selling group.
- (17) Target; old target; new target.
- (18) Target affiliate.
- (19) 12-month acquisition period.
- (d) Time and manner of making election.
- (e) Special rules for foreign corporations or DISCs.
  - (1) Elections by certain foreign purchasing corporations.
    - (i) General rule.
    - (ii) Qualifying foreign purchasing corporation.
    - (iii) Qualifying foreign target.
    - (iv) Triggering event.
    - (v) Subject to United States tax.
  - (2) Acquisition period.
  - (3) Statement of section 338 may be filed by United States shareholders in certain cases.
  - (4) Notice requirement for U.S. persons holding stock in foreign market.
    - (i) General rule.
    - (ii) Limitation.
    - (iii) Form of notice.
    - (iv) Timing of notice.
    - (v) Consequence of failure to comply.
    - (vi) Good faith effort to comply.

#### *§1.338–3 Qualification for the section 338 election.*

- (a) Scope.
- (b) Rules relating to qualified stock purchases.
  - (1) Purchasing corporation requirement.
  - (2) Purchase.
    - (i) Definition.
    - (ii) Purchase of target.
    - (iii) Purchase of target affiliate.
  - (3) Acquisitions of stock from related corporations.
    - (i) In general.
    - (ii) Time for testing relationship.
    - (iii) Cases where section 338(h)(3)(C) applies—acquisitions treated as purchases.
  - (iv) Examples.
- (4) Acquisition date for tiered targets.
  - (i) Stock sold in deemed asset sale.
  - (ii) Examples.
- (5) Effect of redemptions.
  - (i) General rule.
  - (ii) Redemptions from persons unrelated to the purchasing corporation.

- (iii) Redemptions from the purchasing corporation or related persons during 12-month acquisition period.
- (A) General rule.
- (B) Exception for certain redemptions from related corporations.
- (iv) Examples.
- (c) Effect of post-acquisition events on eligibility for section 338 election.
- (1) Post-acquisition elimination of target.
- (2) Post-acquisition elimination of the purchasing corporation.
- (3) Consequences of post-acquisition elimination of target.
- (i) Scope.
- (ii) Continuity of interest.
- (iii) Control requirement.
- (iv) Example.

*§1.338-4 Aggregate deemed sale price; various aspects of taxation of the deemed asset sale.*

- (a) Scope.
- (b) Determination of ADSP.
- (1) General rule.
- (2) Time and amount of ADSP.
- (i) Original determination.
- (ii) Redetermination of ADSP.
- (iii) Example.
- (c) Grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock.
- (1) Determination of amount.
- (2) Example.
- (d) Liabilities of old target.
- (1) In general.
- (2) Time and amount of liabilities.
- (3) Interaction with deemed sale gain.
- (e) Calculation of deemed sale gain.
- (f) Other rules apply in determining ADSP.
- (g) Examples.
- (h) Deemed sale of target affiliate stock.
- (1) Scope.
- (2) In general.
- (3) Deemed sale of foreign target affiliate by a domestic target.
- (4) Deemed sale producing effectively connected income.
- (5) Deemed sale of insurance company target affiliate electing under section 953(d).
- (6) Deemed sale of DISC target affiliate.
- (7) Anti-stuffing rule.
- (8) Examples.

*§1.338-5 Adjusted grossed-up basis.*

- (a) Scope.
- (b) Determination of AGUB.
- (1) General rule.
- (2) Time and amount of AGUB.
- (i) Original determination.
- (ii) Redetermination of AGUB.
- (iii) Examples.
- (c) Grossed-up basis of recently purchased stock.
- (d) Basis of nonrecently purchased stock; gain recognition election.
- (1) No gain recognition election.
- (2) Procedure for making gain recognition election.
- (3) Effect of gain recognition election.
- (i) In general.
- (ii) Basis amount.
- (iii) Losses not recognized.
- (iv) Stock subject to election.
- (e) Liabilities of new target.
- (1) In general.
- (2) Time and amount of liabilities.
- (3) Interaction with deemed sale gain.
- (f) Adjustments by the Internal Revenue Service.
- (g) Examples.

*§1.338-6 Allocation of ADSP and AGUB among target assets.*

- (a) Scope.
- (1) In general.
- (2) Fair market value.
- (i) In general.
- (ii) Transaction costs.
- (iii) Internal Revenue Service authority.
- (b) General rule for allocating ADSP and AGUB.
- (1) Reduction in the amount of consideration for Class I assets.
- (2) Other assets.
- (i) In general.
- (ii) Class II assets.
- (iii) Class III assets.
- (iv) Class IV assets.
- (v) Class V assets.
- (vi) Class VI assets.
- (vii) Class VII assets.
- (3) Other items designated by the Internal Revenue Service.
- (c) Certain limitations and other rules for allocation to an asset.
- (1) Allocation not to exceed fair market value.
- (2) Allocation subject to other rules.
- (3) Special rule for allocating AGUB when purchasing corporation has nonrecently purchased stock.

- (i) Scope.
- (ii) Determination of hypothetical purchase price.
- (iii) Allocation of AGUB.
- (4) Liabilities taken into account in determining amount realized on subsequent disposition.
- (d) Examples.

*§1.338-7 Allocation of redetermined ADSP and AGUB among target assets.*

- (a) Scope.
- (b) Allocation of redetermined ADSP and AGUB.
- (c) Special rules for ADSP.
- (1) Increases or decreases in deemed sale gain taxable notwithstanding old target ceases to exist.
- (2) Procedure for transactions in which section 338(h)(10) is not elected.
- (i) Deemed sale gain included in new target's return.
- (ii) Carryovers and carrybacks.
- (A) Loss carryovers to new target taxable years.
- (B) Loss carrybacks to taxable years of old target.
- (C) Credit carryovers and carrybacks.
- (3) Procedure for transactions in which section 338(h)(10) is elected.
- (d) Special rules for AGUB.
- (1) Effect of disposition or depreciation of acquisition date assets.
- (2) Section 38 property.
- (e) Examples.

*§1.338-8 Asset and stock consistency.*

- (a) Introduction.
- (1) Overview.
- (2) General application.
- (3) Extension of the general rules.
- (4) Application where certain dividends are paid.
- (5) Application to foreign target affiliates.
- (6) Stock consistency.
- (b) Consistency for direct acquisitions.
- (1) General rule.
- (2) Section 338(h)(10) elections.
- (c) Gain from disposition reflected in basis of target stock.
- (1) General rule.
- (2) Gain not reflected if section 338 election made for target.
- (3) Gain reflected by reason of distributions.
- (4) Controlled foreign corporations.



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| (5) Gain recognized outside the consolidated group.   | (A) Purchase by conduit.  | (ii) Gain and loss offsets.  |
| (d) Basis of acquired assets.   | (B) Purchase of conduit by corporation.   | (iii) Procedure for filing a combined return.  |
| (1) Carryover basis rule.   | (C) Purchase of conduit by conduit.   | (iv) Consequences of filing a combined return.   |
| (2) Exceptions to carryover basis rule for certain assets.  | (4) Conduit.  | (5) Deemed sale excluded from purchasing corporation's consolidated return.  |
| (3) Exception to carryover basis rule for <i>de minimis</i> assets.   | (5) Existence of arrangement.   | (6) Due date for old target's final return.  |
| (4) Mitigation rule.  | (6) Predecessor and successor.  | (i) General rule.  |
| (i) General rule.   | (i) Persons.  | (ii) Application of §1.1502-76(c).   |
| (ii) Time for transfer.   | (ii) Assets.  | (A) In general.  |
| (e) Examples.   | (7) Examples.   | (B) Deemed extension.  |
| (1) In general.   | <i>§1.338-9 International aspects of section 338.</i>   | (C) Erroneous filing of deemed sale return.  |
| (2) Direct acquisitions.  | (a) Scope.  | (D) Erroneous filing of return for regular tax year.   |
| (f) Extension of consistency to indirect acquisitions.  | (b) Application of section 338 to foreign targets.  | (E) Last date for payment of tax.  |
| (1) Introduction.   | (1) In general.   | (7) Examples.  |
| (2) General rule.   | (2) Ownership of FT stock on the acquisition date.  | (b) Waiver.  |
| (3) Basis of acquired assets.   | (3) Carryover FT stock.   | (1) Certain additions to tax.  |
| (4) Examples.   | (i) Definition.   | (2) Notification.  |
| (g) Extension of consistency if dividends qualifying for 100 percent dividends received deduction are paid. | (ii) Carryover of earnings and profits.   | (3) Elections or other actions required to be specified on a timely filed return.  |
| (1) General rule for direct acquisitions from target.   | (iii) Cap on carryover of earnings and profits.   | (i) In general.  |
| (2) Other direct acquisitions having same effect.   | (iv) Post-acquisition date distribution of old FT earnings and profits.                         | (ii) New target in purchasing corporation's consolidated return.   |
| (3) Indirect acquisitions.  | (v) Old FT earnings and profits unaffected by post-acquisition date deficits.                   | (4) Examples.  |
| (4) Examples.   | (vi) Character of FT stock as carryover FT stock eliminated upon disposition.                   | <i>§1.338(h)(10)-1 Deemed asset sale and liquidation.</i>  |
| (h) Consistency for target affiliates that are controlled foreign corporations.                             | (4) Passive foreign investment company stock.   | (a) Scope.   |
| (1) In general.   | (c) Dividend treatment under section 1248(e).   | (b) Definitions.   |
| (2) Income or gain resulting from asset dispositions.   | (d) Allocation of foreign taxes.  | (1) Consolidated target.   |
| (i) General rule.   | (e) Operation of section 338(h)(16). [Reserved]   | (2) Selling consolidated group.  |
| (ii) Basis of controlled foreign corporation stock.   | (f) Examples.   | (3) Selling affiliate; affiliated target.  |
| (iii) Operating rule.   | <i>§1.338-10 Filing of returns.</i>   | (4) S corporation target   |
| (iv) Increase in asset or stock basis.  | (a) Returns including tax liability from deemed asset sale.                                     | (5) S corporation shareholders.  |
| (3) Stock issued by target affiliate that is a controlled foreign corporation.                              | (1) In general.   | (6) Liquidation.   |
| (4) Certain distributions.  | (2) Old target's final taxable year otherwise included in consolidated return of selling group. | (c) Section 338(h)(10) election.   |
| (i) General rule.   | (i) General rule.   | (1) In general.  |
| (ii) Basis of controlled foreign corporation stock.   | (ii) Separate taxable year.   | (2) Simultaneous joint election requirement.   |
| (iii) Increase in asset or stock basis.   | (iii) Carryover and carryback of tax attributes.  | (3) Irrevocability.  |
| (5) Examples.   | (iv) Old target is a component member of purchasing corporation's controlled group.             | (4) Effect of invalid election.  |
| (i) [Reserved]  | (3) Old target is an S corporation.   | (d) Certain consequences of section 338(h)(10) election.   |
| (j) Anti-avoidance rules.   | (4) Combined deemed sale return.  | (1) P.   |
| (1) Extension of consistency rules.   | (i) General rule.   | (2) New T.   |
| (2) Qualified stock purchase and 12-month acquisition period.   |   | (3) Old T—deemed sale.   |
| (3) Acquisitions by conduits.   |   | (i) In general.  |
| (i) Asset ownership.  |   | (ii) Tiered targets.   |
| (A) General rule.   |   | (4) Old T and selling consolidated group, selling affiliate, or S corporation shareholders—deemed liquidation; tax characterization. |
| (B) Application of carryover basis rule.  |   | (i) In general.  |
| (ii) Stock acquisitions.  |   |  |

- (ii) Tiered targets.
- (5) Selling consolidated group, selling affiliate, or S corporation shareholders.
  - (i) In general.
  - (ii) Basis and holding period of T stock not acquired.
  - (iii) T stock sale.
- (6) Nonselling minority shareholders other than nonselling S corporation shareholders.
  - (i) In general.
  - (ii) T stock sale.
  - (iii) T stock not acquired.
- (7) Consolidated return of selling consolidated group.
- (8) Availability of the section 453 installment method.
  - (i) In deemed asset sale.
  - (ii) In deemed liquidation.
- (9) Treatment consistent with an actual asset sale.
- (e) Examples.
- (f) Inapplicability of provisions.
- (g) Required information.

*§1.338(i)-1 Effective dates.*

*§1.338-1 General principles; status of old target and new target.*

(a) *In general*—(1) *Deemed transaction.* Elections are available under section 338 when a purchasing corporation acquires the stock of another corporation (the target) in a qualified stock purchase. One type of election, under section 338(g), is available to the purchasing corporation. Another type of election, under section 338(h)(10), is, in more limited circumstances, available jointly to the purchasing corporation and the sellers of the stock. (Rules concerning eligibility for these elections are contained in §§ 1.338-2, 1.338-3, and 1.338(h)(10)-1.) Although target is a single corporation under corporate law, if a section 338 election is made, then two separate corporations, old target and new target, generally are considered to exist for purposes of subtitle A of the Internal Revenue Code. Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the assumption of, or taking subject to, liabilities, and new target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of or taking subject to liabilities.

(Such transaction is, without regard to its characterization for Federal income tax purposes, referred to as the deemed asset sale and the income tax consequences thereof as the deemed sale gain.) If a section 338(h)(10) election is made, old target is also deemed to liquidate following the deemed asset sale.

(2) *Application of other rules of law.* Other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur under section 338 and the regulations hereunder except to the extent otherwise provided in the regulations hereunder. See also §1.338-6(c)(2). Other rules of law may characterize the transaction as something other than or in addition to a sale and purchase of assets; however, it must be a taxable transaction. For example, if target is an insurance company for which a section 338 election is made, the deemed asset sale would be characterized and taxed as an assumption-reinsurance transaction under applicable Federal income tax law. See §1.817-4(d).

(3) *Overview.* Definitions and special nomenclature and rules for making the section 338 election are provided in §1.338-2. Qualification for the section 338 election is addressed in §1.338-3. The amount for which old target is treated as selling all of its assets (the aggregate deemed sale price, or ADSP) is addressed in §1.338-4. The amount for which new target is deemed to have purchased all its assets (the adjusted grossed-up basis, or AGUB) is addressed in §1.338-5. Section 1.338-6 addresses allocation both of ADSP among the assets old target is deemed to have sold and of AGUB among the assets new target is deemed to have purchased. Section 1.338-7 addresses allocation of ADSP or AGUB when those amounts change after the close of new target's first taxable year. Asset and stock consistency are addressed in §1.338-8. International aspects of section 338 are covered in §1.338-9. Rules for the filing of returns are provided in §1.338-10. Eligibility for and treatment of section 338(h)(10) elections is addressed in §1.338(h)(10)-1.

(b) *Treatment of target under other provisions of the Internal Revenue Code*—(1) *General rule for subtitle A.* Except as provided in this section, new target is treated as a new corporation that is unre-

lated to old target for purposes of subtitle A of the Internal Revenue Code. Thus—

(i) New target is not considered related to old target for purposes of section 168 and may make new elections under section 168 without taking into account the elections made by old target; and

(ii) New target may adopt, without obtaining prior approval from the Commissioner, any taxable year that meets the requirements of section 441 and any method of accounting that meets the requirements of section 446. Notwithstanding §1.441-1T(b)(2), a new target may adopt a taxable year on or before the last day for making the election under section 338 by filing its first return for the desired taxable year on or before that date.

(2) *Exceptions for subtitle A.* New target and old target are treated as the same corporation for purposes of—

(i) The rules applicable to employee benefit plans (including those plans described in sections 79, 104, 105, 106, 125, 127, 129, 132, 137, and 220), qualified pension, profit-sharing, stock bonus and annuity plans (sections 401(a) and 403(a)), simplified employee pensions (section 408(k)), tax qualified stock option plans (sections 422 and 423), welfare benefit funds (sections 419, 419A, 512(a)(3), and 4976), voluntary employee benefit associations (section 501(c)(9) and the regulations thereunder);

(ii) Sections 1311 through 1314 (relating to the mitigation of the effect of limitations) if a section 338(h)(10) election is not made for target;

(iii) Section 108(e)(5) (relating to the reduction of purchase money debt);

(iv) Section 45A (relating to the Indian Employment Credit), section 51 (relating to the Work Opportunity Credit), section 51A (relating to the Welfare to Work Credit), and section 1396 (relating to the Empowerment Zone Act);

(v) Sections 401(h) and 420 (relating to medical benefits for retirees);

(vi) Section 414 (relating to definitions and special rules); and

(vii) Any other provision designated in the Internal Revenue Bulletin by the Internal Revenue Service. See §601.601(d)-(2)(ii) of this chapter (relating to the Internal Revenue Bulletin). See §1.1001-3(e)(4)(F) providing that an election under section 338 does not result in the substitution of a new obligor on target's debt.

(3) *General rule for other provisions of the Internal Revenue Code.* Except as provided in the regulations under section 338 or in the Internal Revenue Bulletin by the Internal Revenue Service (see §601.601(d)(2)(ii) of this chapter), new target is treated as a continuation of old target for purposes other than subtitle A of the Internal Revenue Code. For example—

(i) New target is liable for old target's Federal income tax liabilities, including the tax liability for the deemed sale gain and those tax liabilities of the other members of any consolidated group that included old target that are attributable to taxable years in which those corporations and old target joined in the same consolidated return (see §1.1502-6(a));

(ii) Wages earned by the employees of old target are considered wages earned by such employees from new target for purposes of sections 3101 and 3111 (Federal Insurance Contributions Act) and section 3301 (Federal Unemployment Tax Act); and

(iii) Old target and new target must use the same employer identification number.

(c) *Anti-abuse rule*—(1) *In general.* For purposes of applying the residual method of §§1.338-0 through 1.338-10, 1.338(h)(10)-1, and 1.338(i)-1, the Commissioner is authorized to treat any property (including cash) transferred by old target in connection with the transactions resulting in the application of the residual method as, nonetheless, property of target at the close of the acquisition date if the property so transferred, within 24 months after the deemed asset sale, is owned by new target, or is owned, directly or indirectly, by a member of the affiliated group of which new target is a member and continues after the election to be held or used to more than an insignificant extent in connection with one or more of the activities of new target. The Commissioner is authorized to treat any property (including cash) transferred to old target in connection with the transactions resulting in the application of the residual method as, nonetheless, not being property of target at the close of the acquisition date if the property so transferred by the transferor is, within 24 months after the deemed asset sale, not owned by new target but owned, directly or indirectly, by a member of the affiliated group of which new

target is a member or owned by new target but held or used to more than an insignificant extent in connection with an activity conducted, directly or indirectly, by another member of the affiliated group of which new target is a member in combination with other property acquired, directly or indirectly, from the transferor of the property (or a member of the same affiliated group) to old target. For purposes of this paragraph (c)(1), an interest in an entity is considered held or used in connection with an activity if property of the entity is so held or used. The authority under this paragraph (c)(1) includes the making of any necessary correlative adjustments.

(2) *Examples.* The following examples illustrate this paragraph (c):

*Example 1.* Prior to a qualified stock purchase under section 338, target transfers one of its assets to a related party. The purchasing corporation then purchases the target stock and also purchases the transferred asset from the related party. After its purchase of target, the purchasing corporation and target are members of the same affiliated group. A section 338 election is made. Under an arrangement with the purchaser, target continues to use the separately transferred asset to more than an insignificant extent in connection with its own activities. Applying the anti-abuse rule of this paragraph (c), the Commissioner may consider target to own the transferred asset for purposes of applying section 338 and its allocation rules.

*Example 2.* Target (T) owns all the stock of T1. T1 leases intellectual property to T, which T uses in connection with its own activities. P, a purchasing corporation, wishes to buy the T-T1 chain of corporations. P, in connection with its planned purchase of the T stock, contracts to consummate a purchase of all the stock of T1 on March 1 and of all the stock of T on March 2. Section 338 elections are thereafter made for both T and T1. Immediately after the purchases, P, T and T1 are members of the same affiliated group. T continues to lease the intellectual property from T1 and to use the property to more than an insignificant extent in connection with its own activities. Thus, an asset of T, the T1 stock, was removed from T's own assets prior to the qualified stock purchase of the T stock, T1's own assets are used after the deemed asset sale in connection with T's own activities, and the T1 stock is after the deemed asset sale owned by P, a member of the same affiliated group of which T is a member. Applying the anti-abuse rule of this paragraph (c), the Commissioner may, for purposes of application of section 338 both to T and to T1, consider P to have bought only the stock of T, with T at the time of the qualified stock purchases of both T and T1 (the qualified stock purchase of T1 being triggered by the deemed sale under section 338 of T's assets) owning T1. The Commissioner would accordingly apply section 338 first at the T level and then at the T1 level.

§1.338-2 *Nomenclature and definitions; mechanics of the section 338 election.*

(a) *Scope.* This section prescribes rules relating to elections under section 338.

(b) *Nomenclature.* For purposes of the regulations under section 338 (except as otherwise provided):

(1) T is a domestic target corporation that has only one class of stock outstanding. Old T refers to T for periods ending on or before the close of T's acquisition date; new T refers to T for subsequent periods.

(2) P is the purchasing corporation.

(3) The P group is an affiliated group of which P is a member.

(4) P1, P2, etc., are domestic corporations that are members of the P group.

(5) T1, T2, etc., are domestic corporations that are target affiliates of T. These corporations (T1, T2, etc.) have only one class of stock outstanding and may also be targets.

(6) S is a domestic corporation (unrelated to P and B) that owns T prior to the purchase of T by P. (S is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by a domestic corporation.)

(7) A, a U.S. citizen or resident, is an individual (unrelated to P and B) who owns T prior to the purchase of T by P. (A is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by an individual who is a U.S. citizen or resident. Ownership of T by A and ownership of T by S are mutually exclusive circumstances.)

(8) B, a U.S. citizen or resident, is an individual (unrelated to T, S, and A) who owns the stock of P.

(9) F, used as a prefix with the other terms in this paragraph (b), connotes foreign, rather than domestic, status. For example, FT is a foreign corporation (as defined in section 7701(a)(5)) and FA is an individual other than a U.S. citizen or resident.

(10) CFC, used as a prefix with the other terms in this paragraph (b) referring to a corporation, connotes a controlled foreign corporation (as defined in section 957, taking into account section 953(c)). A corporation identified with the prefix F may be a controlled foreign corporation.



The prefix CFC is used when the corporation's status as a controlled foreign corporation is significant.

(c) *Definitions.* For purposes of the regulations under section 338 (except as otherwise provided):

(1) *Acquisition date.* The term *acquisition date* has the same meaning as in section 338(h)(2).

(2) *Acquisition date assets.* *Acquisition date assets* are the assets of the target held at the beginning of the day after the acquisition date (other than assets that were not assets of old target).

(3) *Affiliated group.* The term *affiliated group* has the same meaning as in section 338(h)(5). Corporations are affiliated on any day they are members of the same affiliated group.

(4) *Common parent.* The term *common parent* has the same meaning as in section 1504.

(5) *Consistency period.* The *consistency period* is the period described in section 338(h)(4)(A) unless extended pursuant to §1.338-8(j)(1).

(6) *Deemed asset sale.* The *deemed asset sale* is the transaction described in §1.338-1(a)(1) that is deemed to occur for purposes of subtitle A of the Internal Revenue Code if a section 338 election is made.

(7) *Deemed sale gain.* *Deemed sale gain* refers to, in the aggregate, the Federal income tax consequences (generally, the income, gain, deduction, and loss) of the deemed asset sale. *Deemed sale gain* also refers to the Federal income tax consequences of the transfer of a particular asset in the deemed asset sale.

(8) *Deemed sale return.* The *deemed sale return* is the return on which target's deemed sale gain is reported that does not include any other items of target. Target files a deemed sale return when a section 338 election (but not a section 338(h)(10) election) is filed for target and target is a member of a selling group (defined in paragraph (c)(16) of this section) that files a consolidated return for the period that includes the acquisition date or is an S corporation. See §1.338-10.

(9) *Domestic corporation.* A *domestic corporation* is a corporation—

(i) That is domestic within the meaning of section 7701(a)(4) or that is treated as domestic for purposes of subtitle A of the Internal Revenue Code (e.g., to which an

election under section 953(d) or 1504(d) applies); and

(ii) That is not a DISC, a corporation described in section 1248(e), or a corporation to which an election under section 936 applies.

(10) *Old target's final return.* *Old target's final return* is the income tax return of old target for the taxable year ending at the close of the acquisition date that includes the deemed sale gain. If the disaffiliation rule of §1.338-10(a)(2)(i) applies or if target is an S corporation, target's deemed sale return is considered old target's final return.

(11) *Purchasing corporation.* The term *purchasing corporation* has the same meaning as in section 338(d)(1). The purchasing corporation may also be referred to as purchaser. Unless otherwise provided, any reference to the purchasing corporation is a reference to all members of the affiliated group of which the purchasing corporation is a member. See sections 338(h)(5) and (8). Also, unless otherwise provided, any reference to the purchasing corporation is, with respect to a deemed purchase of stock under section 338(a)(2), a reference to new target with respect to its own deemed purchase of stock in another target.

(12) *Qualified stock purchase.* The term *qualified stock purchase* has the same meaning as in section 338(d)(3).

(13) *Related persons.* Two persons are related if stock in a corporation owned by one of the persons would be attributed under section 318(a) (other than section 318(a)(4)) to the other.

(14) *Section 338 election.* A *section 338 election* is an election to apply section 338(a) to target. A section 338 election is made by filing a statement of section 338 election pursuant to §1.338-2(d). The form on which this statement is filed is referred to in the regulations under section 338 as the Form 8023 Elections Under Section 338 for Corporations Making Qualified Stock Purchases.

(15) *Section 338(h)(10) election.* A *section 338(h)(10) election* is an election to apply section 338(h)(10) to target. A section 338(h)(10) election is made by making a joint election for target under §1.338(h)(10)-1.

(16) *Selling group.* The *selling group* is the affiliated group (as defined in section 1504) eligible to file a consolidated

return that includes target for the taxable period in which the acquisition date occurs. However, a selling group is not an affiliated group of which target is the common parent on the acquisition date.

(17) *Target; old target; new target.* *Target* is the target corporation as defined in section 338(d)(2). *Old target* refers to target for periods ending on or before the close of target's acquisition date. *New target* refers to target for subsequent periods.

(18) *Target affiliate.* The term *target affiliate* has the same meaning as in section 338(h)(6) (applied without section 338(h)(6)(B)(i)). Thus, a corporation described in section 338(h)(6)(B)(i) is considered a target affiliate for all purposes of section 338. If a target affiliate is acquired in a qualified stock purchase, it is also a target.

(19) *12-Month acquisition period.* The *12-month acquisition period* is the period described in section 338(h)(1), unless extended pursuant to §1.338-8(j)(2).

(d) *Time and manner of making election.* The purchasing corporation makes a section 338 election for target by filing a statement of section 338 election on Form 8023 in accordance with the instructions to the form. The section 338 election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. A section 338 election is irrevocable. See §1.338(h)(10)-1(c)(2) for section 338(h)(10) elections.

(e) *Special rules for foreign corporations or DISCs—*(1) *Elections by certain foreign purchasing corporations—*(i) *General rule.* A qualifying foreign purchasing corporation is not required to file a statement of section 338 election for a qualifying foreign target before the earlier of 3 years after the acquisition date and the 180th day after the close of the purchasing corporation's taxable year within which a triggering event occurs.

(ii) *Qualifying foreign purchasing corporation.* A purchasing corporation is a *qualifying foreign purchasing corporation* only if, during the acquisition period of a qualifying foreign target, all the corporations in the purchasing corporation's affiliated group are foreign corporations that are not subject to United States tax.

(iii) *Qualifying foreign target.* A target is a *qualifying foreign target* only if target and its target affiliates are foreign corpo-

rations that, during target's acquisition period, are not subject to United States tax (and will not become subject to United States tax during such period because of a section 338 election). A target affiliate is taken into account for purposes of the preceding sentence only if, during target's 12-month acquisition period, it is or becomes a member of the affiliated group that includes the purchasing corporation.

(iv) *Triggering event.* A triggering event occurs in the taxable year of the qualifying foreign purchasing corporation in which either that corporation or any corporation in its affiliated group becomes subject to United States tax.

(v) *Subject to United States tax.* For purposes of this paragraph (e)(1), a foreign corporation is considered subject to United States tax—

(A) For the taxable year for which that corporation is required under §1.6012-2(g) (other than §1.6012-2(g)(2)(i)-(B)(2)) to file a United States income tax return; or

(B) For the period during which that corporation is a controlled foreign corporation, a passive foreign investment company for which an election under section 1295 is in effect, a foreign investment company, or a foreign corporation the stock ownership of which is described in section 552(a)(2).

(2) *Acquisition period.* For purposes of this paragraph (e), the term acquisition period means the period beginning on the first day of the 12-month acquisition period and ending on the acquisition date.

(3) *Statement of section 338 election may be filed by United States shareholders in certain cases.* The United States shareholders (as defined in section 951(b)) of a foreign purchasing corporation that is a controlled foreign corporation (as defined in section 957 (taking into account section 953(c))) may file a statement of section 338 election on behalf of the purchasing corporation if the purchasing corporation is not required under §1.6012-2(g) (other than §1.6012-2(g)(2)(i)-(B)(2)) to file a United States income tax return for its taxable year that includes the acquisition date. Form 8023 must be filed as described in the form and its instructions and also must be attached to the Form 5471 (information return with respect to a foreign corporation) filed

with respect to the purchasing corporation by each United States shareholder for the purchasing corporation's taxable year that includes the acquisition date (or, if paragraph (e)(1)(i) of this section applies to the election, for the purchasing corporation's taxable year within which it becomes a controlled foreign corporation). The provisions of §1.964-1(c) (including §1.964-1(c)(7)) do not apply to an election made by the United States shareholders.

(4) *Notice requirement for U.S. persons holding stock in foreign market—(i) General rule.* If a target subject to a section 338 election was a controlled foreign corporation, a passive foreign investment company, or a foreign personal holding company at any time during the portion of its taxable year that ends on its acquisition date, the purchasing corporation must deliver written notice of the election (and a copy of Form 8023, its attachments and instructions) to—

(A) Each U.S. person (other than a member of the affiliated group of which the purchasing corporation is a member (the purchasing group member)) that, on the acquisition date of the foreign target, holds stock in the foreign target; and

(B) Each U.S. person (other than a purchasing group member) that sells stock in the foreign target to a purchasing group member during the foreign target's 12-month acquisition period.

(ii) *Limitation.* The notice requirement of this paragraph (e)(4) applies only where the section 338 election for the foreign target affects income, gain, loss, deduction, or credit of the U.S. person described in paragraph (e)(4)(i) of this section under section 551, 951, 1248, or 1293.

(iii) *Form of notice.* The notice to U.S. persons must be identified prominently as a notice of section 338 election and must—

(A) Contain the name, address, and employer identification number (if any) of, and the country (and, if relevant, the lesser political subdivision) under the laws of which is organized, the purchasing corporation and the relevant target (i.e., target the stock of which the particular U.S. person held or sold under the circumstances described in paragraph (e)(4)(i) of this section);

(B) Identify those corporations as the purchasing corporation and the foreign target, respectively; and

(C) Contain the following declaration (or a substantially similar declaration): THIS DOCUMENT SERVES AS NOTICE OF AN ELECTION UNDER SECTION 338 FOR THE ABOVE CITED FOREIGN TARGET THE STOCK OF WHICH YOU EITHER HELD OR SOLD UNDER THE CIRCUMSTANCES DESCRIBED IN TREASURY REGULATIONS SECTION 1.338-2(e)(4). FOR POSSIBLE UNITED STATES FEDERAL INCOME TAX CONSEQUENCES UNDER SECTION 551, 951, 1248, OR 1293 OF THE INTERNAL REVENUE CODE OF 1986 THAT MAY APPLY TO YOU, SEE TREASURY REGULATIONS SECTION 1.338-9(b). YOU MAY BE REQUIRED TO ATTACH THE INFORMATION ATTACHED TO THIS NOTICE TO CERTAIN RETURNS.

(iv) *Timing of notice.* The notice required by this paragraph (e) (4) must be delivered to the U.S. person on or before the later of the 120th day after the acquisition date of the particular target or the day on which Form 8023 is filed. The notice is considered delivered on the date it is mailed to the proper address (or an address similar enough to complete delivery), unless the date it is mailed cannot be reasonably determined. The date of mailing will be determined under the rules of section 7502. For example, the date of mailing is the date of U.S. postmark or the applicable date recorded or marked by a designated delivery service.

(v) *Consequence of failure to comply.* A statement of section 338 election is not valid if timely notice is not given to one or more U.S. persons described in this paragraph (e)(4). If the form of notice fails to comply with all requirements of this paragraph (e)(4), the section 338 election is valid, but the waiver rule of §1.338-10(b)(1) does not apply.

(vi) *Good faith effort to comply.* The purchasing corporation will be considered to have complied with this paragraph (e)(4), even though it failed to provide notice or provide timely notice to each person described in this paragraph (e)(4), if the Commissioner determines that the purchasing corporation made a good faith effort to identify and provide timely notice to those U.S. persons.

*§1.338-3 Qualification for the section 338 election.*

(a) *Scope.* This section provides rules on whether certain acquisitions of stock are qualified stock purchases and on other miscellaneous issues under section 338.

(b) *Rules relating to qualified stock purchases—(1) Purchasing corporation requirement.* An individual cannot make a qualified stock purchase of target. Section 338(d)(3) requires, as a condition of a qualified stock purchase, that a corporation purchase the stock of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.

(2) *Purchase—(i) Definition.* The term purchase has the same meaning as in section 338(h)(3).

(ii) *Purchase of target.* A purchase of a share of target stock occurs so long as more than a nominal amount is paid for such share.

(iii) *Purchase of target affiliate.* Stock in a target affiliate acquired by new target in the deemed asset sale of target's assets is considered purchased if, under general principles of tax law, new target is considered to own stock of the target affiliate meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be allocated to target's stock in the target affiliate.

(3) *Acquisitions of stock from related corporations—(i) In general.* Stock acquired by a purchasing corporation from a related corporation (R) is generally not considered acquired by purchase. See section 338(h)(3)(A)(iii).

(ii) *Time for testing relationship.* For purposes of section 338(h)(3)(A)(iii), a purchasing corporation is treated as related to another person if the relationship specified in section 338(h)(3)(A)(iii) exists—

(A) In the case of a single transaction, immediately after the purchase of Target stock;

(B) In the case of a series of acquisitions otherwise constituting a qualified

stock purchase within the meaning of section 338(d)(3), immediately after the last acquisition in such series; and

(C) In the case of a series of transactions effected pursuant to an integrated plan to dispose of Target stock, immediately after the last transaction in such series.

(iii) *Cases where section 338(h)(3)(C) applies—acquisitions treated as purchases.* If section 338(h)(3)(C) applies and the purchasing corporation is treated as acquiring stock by purchase from R, solely for purposes of determining when the stock is considered acquired, target stock acquired from R is considered to have been acquired by the purchasing corporation on the day on which the purchasing corporation is first considered to own that stock under section 318(a) (other than section 318(a)(4)).

(iv) *Examples.* The following examples illustrate this paragraph (b)(3):

*Example 1.* (i) S is the parent of a group of corporations that are engaged in various businesses. Prior to January 1, Year 1, S decided to discontinue its involvement in one line of business. To accomplish this, S forms a new corporation, Newco, with a nominal amount of cash. Shortly thereafter, on January 1, Year 1, S transfers all the stock of the subsidiary conducting the unwanted business (Target) to Newco in exchange for 100 shares of Newco common stock. Prior to January 1, Year 1, S and Underwriter (U) had entered into a binding agreement pursuant to which U would purchase 60 shares of Newco common stock from S and then sell those shares in an Initial Public Offering (IPO). On January 6, Year 1, the IPO closes.

(ii) Newco's acquisition of Target stock is one of a series of transactions undertaken pursuant to one integrated plan. The series of transactions ends with the closing of the IPO and the transfer of all the shares of stock in accordance with the agreements. Immediately after the last transaction effected pursuant to the plan, S owns 40 percent of Newco, which does not give rise to a relationship described in section 338(h)(3)(A)(iii). See §1.338-3(b)-(3)(ii)(C). Accordingly, S and Newco are not related for purposes of section 338(h)(3)(A)(iii).

(iii) Further, because Newco's basis in the Target stock is not determined by reference to S's basis in the Target stock and because the transaction is not an exchange to which section 351, 354, 355, or 356 applies, Newco's acquisition of the Target stock is a purchase within the meaning of section 338(h)(3).

*Example 2.* (i) On January 1 of Year 1, P purchases 75 percent in value of the R stock. On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, R acquires an additional 16 shares of T stock. On December 1 of Year 1, P purchases 70 shares of T stock from an unrelated person and 12 of the 20 shares of T stock held by R.

(ii) Of the 12 shares of T stock purchased by P from R on December 1 of Year 1, 3 of those shares are deemed to have been acquired by P on January 1

of Year 1, the date on which 3 of the 4 shares of T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e.,  $4 \times .75$ ). The remaining 9 shares of T stock purchased by P from R on December 1 of Year 1, are deemed to have been acquired by P on June 1 of Year 1, the date on which an additional 12 of the 20 shares of T stock owned by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e.,  $(20 \times .75) - 3$ ). Because stock acquisitions by P sufficient for a qualified stock purchase of T occur within a 12-month period (i.e., 3 shares constructively on January 1 of Year 1, 9 shares constructively on June 1 of Year 1, and 70 shares actually on December 1 of Year 1), a qualified stock purchase is made on December 1 of Year 1.

*Example 3.* (i) On February 1 of Year 1, P acquires 25 percent in value of the R stock from B (the sole shareholder of P). That R stock is not acquired by purchase. See section 338(h)(3)(A)(iii). On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, P purchases an additional 25 percent in value of the R stock, and on January 1 of Year 2, P purchases another 25 percent in value of the R stock. On June 1 of Year 2, R acquires an additional 16 shares of the T stock. On December 1 of Year 2, P purchases 68 shares of the T stock from an unrelated person and 12 of the 20 shares of the T stock held by R.

(ii) Of the 12 shares of the T stock purchased by P from R on December 1 of Year 2, 2 of those shares are deemed to have been acquired by P on June 1 of Year 1, the date on which 2 of the 4 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e.,  $4 \times .5$ ). For purposes of this attribution, the R stock need not be acquired by P by purchase. See section 338(h)(1). (By contrast, the acquisition of the T stock by P from R does not qualify as a purchase unless P has acquired at least 50 percent in value of the R stock by purchase. Section 338(h)(3)(C)(i).) Of the remaining 10 shares of the T stock purchased by P from R on December 1 of Year 2, 1 of those shares is deemed to have been acquired by P on January 1 of Year 2, the date on which an additional 1 share of the 4 shares of the T stock held by R on that date was first considered owned by P under section 318(a)(2)(C) (i.e.,  $(4 \times .75) - 2$ ). The remaining 9 shares of the T stock purchased by P from R on December 1 of Year 2, are deemed to have been acquired by P on June 1 of Year 2, the date on which an additional 12 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e.,  $(20 \times .75) - 3$ ). Because a qualified stock purchase of T by P is made on December 1 of Year 2, only if all 12 shares of the T stock purchased by P from R on that date are considered acquired during a 12-month period ending on that date (so that, in conjunction with the 68 shares of the T stock P purchased on that date from the unrelated person, 80 of T's 100 shares are acquired by P during a 12-month period) and because 2 of those 12 shares are considered to have been acquired by P more than 12 months before December 1 of Year 2 (i.e., on June 1 of Year 1), a qualified stock purchase is not made. (Under §1.338-8(j)(2), for purposes of applying the consistency rules, P is treated as making a qualified stock purchase of T if, pursuant to an arrangement, P purchases T stock satisfying the re-



quirements of section 1504(a)(2) over a period of more than 12 months.)

*Example 4.* Assume the same facts as in *Example 3*, except that on February 1 of Year 1, P acquires 25 percent in value of the R stock by purchase. The result is the same as in *Example 3*.

(4) *Acquisition date for tiered targets—*

(i) *Stock sold in deemed asset sale.* If an election under section 338 is made for target, old target is deemed to sell target's assets and new target is deemed to acquire those assets. Under section 338(h)(3)(B), new target's deemed purchase of stock of another corporation is a purchase for purposes of section 338(d)(3) on the acquisition date of target. If new target's deemed purchase causes a qualified stock purchase of the other corporation and if a section 338 election is made for the other corporation, the acquisition date for the other corporation is the same as the acquisition date of target. However, the deemed sale and purchase of the other corporation's assets is considered to take place after the deemed sale and purchase of target's assets.

(ii) *Examples.* The following examples illustrate this paragraph (b)(4):

*Example 1.* A owns all of the T stock. T owns 50 of the 100 shares of X stock. The other 50 shares of X stock are owned by corporation Y, which is unrelated to A, T, or P. On January 1 of Year 1, P makes a qualified stock purchase of T from A and makes a section 338 election for T. On December 1 of Year 1, P purchases the 50 shares of X stock held by Y. A qualified stock purchase of X is made on December 1 of Year 1, because the deemed purchase of 50 shares of X stock by new T because of the section 338 election for T and the actual purchase of 50 shares of X stock by P are treated as purchases made by one corporation. Section 338(h)(8). For purposes of determining whether those purchases occur within a 12-month acquisition period as required by section 338(d)(3), T is deemed to purchase its X stock on T's acquisition date, i.e., January 1 of Year 1.

*Example 2.* On January 1 of Year 1, P makes a qualified stock purchase of T and makes a section 338 election for T. On that day, T sells all of the stock of T1 to A. Although T held all of the T1 stock on T's acquisition date, T is not considered to have purchased the T1 stock because of the section 338 election for T. In order for T to be treated as purchasing the T1 stock, T must hold the T1 stock when T's deemed asset sale occurs. The deemed asset sale is considered the last transaction of old T at the close of T's acquisition date. Accordingly, the T1 stock actually disposed of by T on the acquisition date is not included in the deemed asset sale. Thus, T does not make a qualified stock purchase of T1.

(5) *Effect of redemptions—(i) General rule.* Except as provided in this paragraph (b)(5), a qualified stock purchase is

made on the first day on which the percentage ownership requirements of section 338(d)(3) are satisfied by reference to target stock that is both—

(A) Held on that day by the purchasing corporation; and

(B) Purchased by the purchasing corporation during the 12-month period ending on that day.

(ii) *Redemptions from persons unrelated to the purchasing corporation.* Target stock redemptions from persons unrelated to the purchasing corporation that occur during the 12-month acquisition period are taken into account as reductions in target's outstanding stock for purposes of determining whether target stock purchased by the purchasing corporation in the 12-month acquisition period satisfies the percentage ownership requirements of section 338(d)(3).

(iii) *Redemptions from the purchasing corporation or related persons during 12-month acquisition period—(A) General rule.* For purposes of the percentage ownership requirements of section 338(d)(3), a redemption of target stock during the 12-month acquisition period from the purchasing corporation or from any person related to the purchasing corporation is not taken into account as a reduction in target's outstanding stock.

(B) *Exception for certain redemptions from related corporations.* A redemption of target stock during the 12-month acquisition period from a corporation related to the purchasing corporation is taken into account as a reduction in target's outstanding stock to the extent that the redeemed stock would have been considered purchased by the purchasing corporation (because of section 338(h)-(3)(C)) during the 12-month acquisition period if the redeemed stock had been acquired by the purchasing corporation from the related corporation on the day of the redemption. See paragraph (b)(3) of this section.

(iv) *Examples.* The following examples illustrate this paragraph (b)(5):

*Example 1. QSP on stock purchase date; redemption from unrelated person during 12-month period.* A owns all 100 shares of T stock. On January 1 of Year 1, P purchases 40 shares of the T stock from A. On July 1 of Year 1, T redeems 25 shares from A. On December 1 of Year 1, P purchases 20 shares of the T stock from A. P makes a qualified stock purchase of T on December 1 of Year 1, because the 60 shares of T stock purchased by P within

the 12-month period ending on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

*Example 2. QSP on stock redemption date; redemption from unrelated person during 12-month period.* The facts are the same as in *Example 1*, except that P purchases 60 shares of T stock on January 1 of Year 1 and none on December 1 of Year 1. P makes a qualified stock purchase of T on July 1 of Year 1, because that is the first day on which the T stock purchased by P within the preceding 12-month period satisfies the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

*Example 3. Redemption from purchasing corporation not taken into account.* On December 15 of Year 1, T redeems 30 percent of its stock from P. The redeemed stock was held by P for several years and constituted P's total interest in T. On December 1 of Year 2, P purchases the remaining T stock from A. P does not make a qualified stock purchase of T on December 1 of Year 2. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of P's T stock on December 15 of Year 1 is not taken into account as a reduction in T's outstanding stock.

*Example 4. Redemption from related person taken into account.* On January 1 of Year 1, P purchases 60 of the 100 shares of X stock. On that date, X owns 40 of the 100 shares of T stock. On April 1 of Year 1, T redeems X's T stock and P purchases the remaining 60 shares of T stock from an unrelated person. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of the T stock from X (a person related to P) is taken into account as a reduction in T's outstanding stock. If P had purchased the 40 redeemed shares from X on April 1 of Year 1, all 40 of the shares would have been considered purchased (because of section 338(h)(3)(C)(i)) during the 12-month period ending on April 1 of Year 1 (24 of the 40 shares would have been considered purchased by P on January 1 of Year 1 and the remaining 16 shares would have been considered purchased by P on April 1 of Year 1). See paragraph (b)(3) of this section. Accordingly, P makes a qualified stock purchase of T on April 1 of Year 1, because the 60 shares of T stock purchased by P on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/60 shares), determined by taking into account the redemption of 40 shares.

(c) *Effect of post-acquisition events on eligibility for section 338 election—(1) Post-acquisition elimination of target.* (i) The purchasing corporation may make an election under section 338 for target even though target is liquidated on or after the acquisition date. If target liquidates on the acquisition date, the liquidation is considered to occur on the following day and immediately after new target's deemed purchase of assets. The purchasing corporation may also make an election under section 338 for target even

though target is merged into another corporation, or otherwise disposed of by the purchasing corporation provided that, under the facts and circumstances, the purchasing corporation is considered for tax purposes as the purchaser of the target stock.

(ii) The following examples illustrate this paragraph (c)(1):

*Example 1.* On January 1 of Year 1, P purchases 100 percent of the outstanding common stock of T. On June 1 of Year 1, P sells the T stock to an unrelated person. Assuming that P is considered for tax purposes as the purchaser of the T stock, P remains eligible, after June 1 of Year 1, to make a section 338 election for T that results in a deemed asset sale of T's assets on January 1 of Year 1.

*Example 2.* On January 1 of Year 1, P makes a qualified stock purchase of T. On that date, T owns the stock of T1. On March 1 of Year 1, T sells the T1 stock to an unrelated person. On April 1 of Year 1, P makes a section 338 election for T. Notwithstanding that the T1 stock was sold on March 1 of Year 1, the section 338 election for T on April 1 of Year 1 results in a qualified stock purchase by T of T1 on January 1 of Year 1. See paragraph (b)(4)(i) of this section.

(2) *Post-acquisition elimination of the purchasing corporation.* An election under section 338 may be made for target after the acquisition of assets of the purchasing corporation by another corporation in a transaction described in section 381(a), provided that the purchasing corporation is considered for tax purposes as the purchaser of the target stock. The acquiring corporation in the section 381(a) transaction may make an election under section 338 for target.

(3) *Consequences of post-acquisition elimination of target—(i) Scope.* The rules of this paragraph (c)(3) apply to the transfer of target assets to the purchasing corporation (or another member of the same affiliated group as the purchasing corporation) (the transferee) following a qualified stock purchase of target stock, if the purchasing corporation does not make a section 338 election for target. Notwithstanding the rules of this paragraph (c)(3), section 354(a) (and so much of section 356 as relates to section 354) cannot apply to any person other than the purchasing corporation or another member of the same affiliated group as the purchasing corporation unless the transfer of target assets is pursuant to a reorganization as determined without regard to this paragraph (c)(3).

(ii) *Continuity of interest.* By virtue of section 338, in determining whether the continuity of interest requirement of §1.368-1(b) is satisfied on the transfer of assets from target to the transferee, the purchasing corporation's target stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of the target's business enterprise prior to the transfer that can be continued in a reorganization.

(iii) *Control requirement.* By virtue of section 338, the acquisition of target stock in the qualified stock purchase will not prevent the purchasing corporation from qualifying as a shareholder of the target transferor for the purpose of determining whether, immediately after the transfer of target assets, a shareholder of the transferor is in control of the corporation to which the assets are transferred within the meaning of section 368(a)(1)(D).

(iv) *Example.* The following example illustrates this paragraph (c)(3):

*Example. (i) Facts.* P, T, and X are domestic corporations. T and X each operate a trade or business. A and K, individuals unrelated to P, own 85 and 15 percent, respectively, of the stock of T. P owns all of the stock of X. The total adjusted basis of T's property exceeds the sum of T's liabilities plus the amount of liabilities to which T's property is subject. P purchases all of A's T stock for cash in a qualified stock purchase. P does not make an election under section 338(g) with respect to its acquisition of T stock. Shortly after the acquisition date, and as part of the same plan, T merges under applicable state law into X in a transaction that, but for the question of continuity of interest, satisfies all the requirements of section 368(a)(1)(A). In the merger, all of T's assets are transferred to X. P and K receive X stock in exchange for their T stock. P intends to retain the stock of X indefinitely.

(ii) *Status of transfer as a reorganization.* By virtue of section 338, for the purpose of determining whether the continuity of interest requirement of §1.368-1(b) is satisfied, P's T stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of T's business enterprise prior to the transfer that can be continued in a reorganization through P's continuing ownership of X. Thus, the continuity of interest requirement is satisfied and the merger of T into X is a reorganization within the meaning of section 368(a)(1)(A). Moreover, by virtue of section 338, the requirement of section 368(a)(1)(D) that a target shareholder control the transferee immediately after the transfer is satisfied because P controls X immediately after the transfer. In addition, all of T's assets are transferred to X in the merger and P and K receive the X stock exchanged therefor in pursuance of the plan of reorganization. Thus, the merger of T into X is also a reorganization within the meaning of section 368(a)(1)(D).

(iii) *Treatment of T and X.* Under section 361(a), T recognizes no gain or loss in the merger. Under section 362(b), X's basis in the assets received in the merger is the same as the basis of the assets in T's hands. X succeeds to and takes into account the items of T as provided in section 381.

(iv) *Treatment of P.* By virtue of section 338, the transfer of T assets to X is a reorganization. Pursuant to that reorganization, P exchanges its T stock solely for stock of X, a party to the reorganization. Because P is the purchasing corporation, section 354 applies to P's exchange of T stock for X stock in the merger of T into X. Thus, P recognizes no gain or loss on the exchange. Under section 358, P's basis in the X stock received in the exchange is the same as the basis of P's T stock exchanged therefor.

(v) *Treatment of K.* Because K is not the purchasing corporation (or an affiliate thereof), section 354 cannot apply to K's exchange of T stock for X stock in the merger of T into X unless the transfer of T's assets is pursuant to a reorganization as determined without regard to §1.338-3(c)(3). Under general principles of tax law applicable to reorganizations, the continuity of interest requirement is not satisfied because P's stock purchase and the merger of T into X are pursuant to an integrated transaction in which A, the owner of 85 percent of the stock of T, received solely cash in exchange for A's T stock. See, e.g., *Yoc Heating v. Commissioner*, 61 T.C. 168 (1973); *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd, 491 F.2d 749 (3d Cir. 1974). Thus, the requisite continuity of interest under §1.368-1(b) is lacking and section 354 does not apply to K's exchange of T stock for X stock. K recognizes gain or loss, if any, pursuant to section 1001(c) with respect to its T stock.

#### **§§1.338-4 and 1.338-5 [Redesignated as §§1.338-8 and 1.338-9]**

Par. 3. Sections 1.338-4 and 1.338-5 are redesignated as §§1.338-8 and 1.338-9, respectively.

Par. 4. New §§1.338-4 and 1.338-5 are added to read as follows:

*§1.338-4 Aggregate deemed sale price; various aspects of taxation of the deemed asset sale.*

(a) *Scope.* This section provides rules under section 338(a)(1) to determine the aggregate deemed sale price (ADSP) for target. ADSP is the amount for which old target is deemed to have sold all of its assets in the deemed asset sale. ADSP is allocated among target's assets in accordance with §1.338-6 to determine the amount for which each asset is deemed to have been sold. When an increase or decrease with respect to an element of ADSP is required, under general principles of tax law, after the close of new target's first taxable year, redetermined



ADSP is allocated among target's assets in accordance with §1.338-7. This section also provides rules regarding the recognition of gain or loss on the deemed sale of target affiliate stock. Notwithstanding section 338(h)(6)(B)(ii), stock held by a target affiliate in a foreign corporation or in a corporation that is a DISC or that is described in section 1248(e) is not excluded from the operation of section 338.

(b) *Determination of ADSP*—(1) *General rule.* ADSP is the sum of—

(i) The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock (as defined in section 338(b)(6)(A)); and

(ii) The liabilities of old target.

(2) *Time and amount of ADSP*—(i) *Original determination.* ADSP is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of ADSP.

(ii) *Redetermination of ADSP.* ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, for the elements of ADSP. For example, ADSP is redetermined because of an increase or decrease in the amount realized for recently purchased stock or because liabilities not originally taken into account in determining ADSP are subsequently taken into account. An increase or decrease to one element of ADSP may cause an increase or decrease to the other element of ADSP. For example, if an increase in the amount realized for recently purchased stock of target is taken into account after the acquisition date, any increase in the tax liability of target for the deemed sale gain is also taken into account when ADSP is redetermined. Increases or decreases with respect to the elements of ADSP that are taken into account before the close of new target's first taxable year are taken into account for purposes of determining ADSP and the deemed sale gain as if they had been taken into account at the beginning of the day after the acquisition date. Increases or decreases with respect to the elements of ADSP that are taken into account after the close of new target's first taxable year result in the reallocation of

ADSP among target's assets under §1.338-7.

(iii) *Example.* The following example illustrates this paragraph (b)(2):

*Example.* In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of \$100,000. P acquires all of the stock of T in Year 3 for \$700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to \$80,000. Assume further that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would not, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its amount realized. Accordingly, ADSP is not redetermined at the time of the reduction. See §1.338-5(b)(2)(iii) *Example 1* for the effect on AGUB.

(c) *Grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock*—(1) *Determination of amount.* The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock is an amount equal to—

(i) The amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock determined as if old target were the selling shareholder and the installment method were not available and determined without regard to the selling costs taken into account in paragraph (c)(1)(iii) of this section;

(ii) Divided by the percentage of target stock (by value, determined on the acquisition date) attributable to that recently purchased target stock;

(iii) Less the selling costs incurred by the selling shareholders in connection with the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock that reduce their amount realized on the sale of the stock (e.g., brokerage commissions and any similar costs to sell the stock).

(2) *Example.* The following example illustrates this paragraph (c):

*Example.* T has two classes of stock outstanding, voting common stock and preferred stock not taken into account for purposes of section 1504(a)(2). On March 1 of Year 1, P purchases 40 percent of the

outstanding T stock from S1 for \$500, 20 percent of the outstanding T stock from S2 for \$225, and 20 percent of the outstanding T stock from S3 for \$275. On that date, the fair market value of all the T voting common stock is \$1,250 and the preferred stock \$750. S1, S2, and S3 respectively incur \$40, \$35, and \$25 of selling costs. S1 continues to own the remaining 20 percent of the outstanding T stock. The grossed-up amount realized on the sale to P of P's recently purchased T stock is calculated as follows: The total amount realized (without regard to selling costs) is \$1,000 ( $500 + 225 + 275$ ). The percentage of T stock by value on the acquisition date attributable to the recently purchased T stock is 50% ( $1,000 / (1,250 + 750)$ ). The selling costs are \$100 ( $40 + 35 + 25$ ). The grossed-up amount realized is \$1,900 ( $1,000 / .5 - 100$ ).

(d) *Liabilities of old target*—(1) *In general.* The liabilities of old target are the liabilities of target (and the liabilities to which target's assets are subject) as of the beginning of the day after the acquisition date (other than liabilities that were neither liabilities of old target nor liabilities to which old target's assets were subject). In order to be taken into account in ADSP, a liability must be a liability of target that is properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included that person's assumption of, or taking subject to, the liability. Thus, ADSP takes into account both tax credit recapture liability arising because of the deemed asset sale and the tax liability for the deemed sale gain unless the tax liability is borne by some person other than the target. For example, ADSP would not take into account the tax liability for the deemed sale gain when a section 338(h)(10) election is made for a target S corporation because the S corporation shareholders bear that liability. However, if a target S corporation is subject to a tax under section 1374 or 1375, the liability for tax imposed by those sections is a liability of target taken into account in ADSP (unless the S corporation shareholders expressly assume that liability).

(2) *Time and amount of liabilities.* The time for taking into account liabilities of old target in determining ADSP and the amount of the liabilities taken into account is determined as if old target had sold its assets to an unrelated person for consideration that included the unrelated person's assumption of or taking subject to the liabilities. For example, if no



amount of a target liability is properly taken into account in amount realized as of the beginning of the day after the acquisition date, the liability is not initially taken into account in determining ADSP (although it may be taken into account at some later date). As a further example, an increase or decrease in a liability that does not affect the amount of old target's basis, deductions, or noncapital nondeductible items arising from the incurrence of the liability is not taken into account in redetermining ADSP.

(3) *Interaction with deemed sale gain.* Though deemed sale gain increases or decreases ADSP by creating or reducing a tax liability, the amount of the tax liability itself is a function of the size of the deemed sale gain. Thus, the determination of ADSP may require trial and error computations.

(e) *Calculation of deemed sale gain.* Deemed sale gain on each asset is computed by reference to the ADSP allocated to that asset.

(f) *Other rules apply in determining ADSP.* ADSP may not be applied in such a way as to contravene other applicable rules. For example, a capital loss cannot be applied to reduce ordinary income in calculating the tax liability on the deemed sale for purposes of determining ADSP.

(g) *Examples.* The following examples illustrate this section. For purposes of the examples in this paragraph (g), unless otherwise stated, T is a calendar year taxpayer that files separate returns and that has no loss, tax credit, or other carryovers to Year 1. Depreciation for Year 1 is not taken into account. T has no liabilities other than the Federal income tax liability resulting from the deemed asset sale, and the T shareholders have no selling costs. Assume that T's tax rate for any ordinary income or net capital gain resulting from the deemed sale of assets is 34 percent and that any capital loss is offset by capital gain. On July 1 of Year 1, P purchases all of the stock of T and makes a section 338 election for T. The examples are as follows:

*Example 1. One class.* (i) On July 1 of Year 1, T's only asset is an item of section 1245 property with an adjusted basis to T of \$50,400, a recomputed basis of \$80,000, and a fair market value of \$100,000. P purchases all of the T stock for \$75,000, which also equals the amount realized for the stock determined as if old target were the selling shareholder.

(ii) ADSP is determined as follows (In the following formula, G is the grossed-up amount realized on the sale to P of P's recently purchased T stock, L is T's liabilities other than T's tax liability for the deemed sale gain, TR is the applicable tax rate, and B is the adjusted basis of the asset deemed sold):

$$ADSP = G + L + T_R \times (ADSP - B)$$

$$\begin{aligned} ADSP &= (\$75,000/1) + \$0 + .34 \times (ADSP - \$50,400) \\ ADSP &= \$75,000 + .34ADSP - \$17,136 \\ 66ADSP &= \$57,864 \\ ADSP &= \$87,672.72 \end{aligned}$$

(iii) Because ADSP for T (\$87,672.72) does not exceed the fair market value of T's asset (\$100,000), a Class V asset, T's entire ADSP is allocated to that asset. Thus, T has deemed sale gain of \$37,272.72 (consisting of \$29,600 of ordinary income and \$7,672.72 of capital gain).

(iv) The facts are the same as in paragraph (i) of this Example 1, except that on July 1 of Year 1, P purchases only 80 of the 100 shares of T stock for \$60,000. The grossed-up amount realized on the sale to P of P's recently purchased T stock (G) is \$75,000 (\$60,000/.8). Consequently, ADSP and deemed sale gain are the same as in paragraphs (ii) and (iii) of this Example 1.

(v) The facts are the same as in paragraph (i) of this Example 1, except that T also has goodwill (a Class VII asset) with an appraised value of \$10,000. The results are the same as in paragraphs (ii) and (iii) of this Example 1. Because ADSP does not exceed the fair market value of the Class V asset, no amount is allocated to the Class VII assets (goodwill and going concern value).

*Example 2. More than one class.* (i) P purchases all of the T stock for \$140,000, which also equals the amount realized for the stock determined as if old target were the selling shareholder. On July 1 of Year 1, T has liabilities (not including the tax liability for the deemed sale gain) of \$50,000, cash (a Class I asset) of \$10,000, actively traded securities (a Class II asset) with a basis of \$4,000 and a fair market value of \$10,000, goodwill (a Class VII asset) with a basis of \$3,000, and the following Class V assets:

Asset	Basis	FMV	Ratio of asset fmv to total Class V fmv
Land .....	\$ 5,000	\$ 35,000	.14
Building .....	10,000	50,000	.20
Equipment A (Recomputed basis \$80,000) .....	5,000	90,000	.36
Equipment B (Recomputed basis \$20,000) .....	10,000	75,000	.30
Totals .....	\$ 30,000	\$ 250,000	1.00

(ii) ADSP exceeds \$20,000. Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities. The amount allocated to an asset (other than a Class VII asset) cannot exceed its fair market value (however, the fair market value of

any property subject to nonrecourse indebtedness is treated as being not less than the amount of such indebtedness; see §1.338-6(a)(2)). See §1.338-6(c)(1) (relating to fair market value limitation).

(iii) The portion of ADSP allocable to the Class V

assets is preliminarily determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I and the amount allocated to the Class II assets as II):

$$\begin{aligned} ADSP_V &= (G - (I + II)) + L + T_R \times [(II - B_{II}) + (ADSP_V - B_V)] \\ ADSP_V &= (\$140,000 - (\$10,000 + \$10,000)) + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (ADSP_V - (\$5,000 + \$10,000 + \$5,000 + \$10,000))] \\ ADSP_V &= \$161,840 + .34 ADSP_V \\ .66 ADSP_V &= \$161,840 \\ ADSP_V &= \$245,212.12 \end{aligned}$$

(iv) Because, under the preliminary calculations of ADSP, the amount to be allocated to the Class I, II, III, IV, V, and VI assets does not exceed their ag-

gregate fair market value, no ADSP amount is allocated to goodwill. Accordingly, the deemed sale of the goodwill results in a capital loss of \$3,000. The

portion of ADSP allocable to the Class V assets is finally determined by taking into account this loss as follows:

$$\begin{aligned} \text{ADSP}_V &= (G - (I + II)) + L + T_R [(II - B_{II}) + (\text{ADSP}_V - B_V) + (\text{ADSP}_{VII} - B_{VII})] \\ \text{ADSP}_V &= (\$140,000 - (\$10,000 + \$10,000)) + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\text{ADSP}_V - \$30,000) + (\$0 - \$3,000)] \\ \text{ADSP}_V &= \$160,820 + .34 \text{ADSP}_V \\ .66 \text{ADSP}_V &= \$160,820 \\ \text{ADSP}_V &= \$243,666.67 \end{aligned}$$

(v) The allocation of ADSPV among the Class V assets is in proportion to their fair market values, as follows:

Asset	ADSP	Gain
Land . . . . .	\$ 34,113.33	\$ 29,113.33 (capital gain)
Building . . . . .	48,733.34	38,733.34 (capital gain)
Equipment A . . . . .	87,720.00	82,720.00 (75,000 ordinary income 7,720 capital gain)
Equipment B . . . . .	73,100.00	63,100.00 (10,000 ordinary income 53,100 capital gain)
Totals . . . . .	\$ 243,666.67	\$ 213,666.67

*Example 3. More than one class.* (i) The facts are the same as in *Example 2*, except that P purchases the T stock for \$150,000, rather than \$140,000. The amount realized for the stock determined as if old target were the selling shareholder is also \$150,000.

(ii) As in *Example 2*, ADSP exceeds \$20,000.

$$\begin{aligned} \text{ADSP} &= G + L + T_R [(II - B_{II}) + (V - B_V) + (\text{ADSP} - (I + II + V + B_{VII}))] \\ \text{ADSP} &= \$150,000 + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\$250,000 - \$30,000) + (\text{ADSP} - (\$10,000 + \$10,000 + \$250,000 + \$3,000))] \\ \text{ADSP} &= \$200,000 + .34\text{ADSP} - \$15,980 \\ .66\text{ADSP} &= \$184,020 \\ \text{ADSP} &= \$278,818.18 \end{aligned}$$

(v) Because ADSP as determined exceeds the aggregate fair market value of the Class I, II, III, IV, V, and VI assets, the \$250,000 amount preliminarily allocated to the Class V assets is appropriate. Thus, the amount of ADSP allocated to Class V assets equals their aggregate fair market value (\$250,000), and the allocated ADSP amount for each Class V asset is its fair market value. Further, because there are no Class VI assets, the allocable ADSP amount for the Class VII asset (goodwill) is \$8,818.18 (the excess of ADSP over the aggregate ADSP amounts for the Class I, II, III, IV, V and VI assets).

*Example 4. Amount allocated to T1 stock.* (i) The facts are the same as in *Example 2*, except that T owns all of the T1 stock (instead of the building), and T1's only asset is the building. The T1 stock and the building each have a fair market value of \$50,000, and the building has a basis of \$10,000. A section 338 election is made for T1 (as well as T), and T1 has no liabilities other than the tax liability for the deemed sale gain. T is the common parent of a consolidated group filing a final consolidated return described in §1.338-10(a)(1).

(ii) ADSP exceeds \$20,000. Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities.

(iii) Because T does not recognize any gain on the deemed sale of the T1 stock under paragraph (h)(2) of this section, appropriate adjustments must be made to reflect accurately the fair market value of the T and T1 assets in determining the allocation of

Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities.

(iii) The portion of ADSP allocable to the Class V assets as preliminarily determined under the formula set forth in paragraph (iii) of *Example 2* is \$260,363.64. The amount allocated to the Class V assets cannot exceed their aggregate fair market

value (\$250,000). Thus, preliminarily, the ADSP amount allocated to Class V assets is \$250,000.

(iv) Based on the preliminary allocation, the ADSP is determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I, the amount allocated to the Class II assets as II, and the amount allocated to the Class V assets as V):

ADSP among T's Class V assets (including the T1 stock). In preliminarily calculating ADSPV in this case, the T1 stock can be disregarded and, because T owns all of the T1 stock, the T1 asset can be treated as a T asset. Under this assumption, ADSPV is \$243,666.67. See paragraph (iv) of *Example 2*.

(iv) Because the portion of the preliminary ADSP allocable to Class V assets (\$243,666.67) does not exceed their fair market value (\$250,000), no amount is allocated to Class VII assets for T. Further, this amount (\$243,666.67) is allocated among T's Class V assets in proportion to their fair market values. See paragraph (v) of *Example 2*. Tentatively, \$48,733.34 of this amount is allocated to the T1 stock.

(v) The amount tentatively allocated to the T1 stock, however, reflects the tax incurred on the deemed sale of the T1 asset equal to \$13,169.34 (.34 × (\$48,733.34 - \$10,000)). Thus, the ADSP allocable to the Class V assets of T, and the ADSP allocable to the T1 stock, as preliminarily calculated, each must be reduced by \$13,169.34. Consequently, these amounts, respectively, are \$230,497.33 and \$35,564.00. In determining ADSP for T1, the grossed-up amount realized on the deemed sale to new T of new T's recently purchased T1 stock is \$35,564.00.

(vi) The facts are the same as in paragraph (i) of this Example 4, except that the T1 building has a \$12,500 basis and a \$62,500 value, all of the outstanding T1 stock has a \$62,500 value, and T owns 80 percent of the T1 stock. In preliminarily calculat-

ing ADSPV, the T1 stock can be disregarded but, because T owns only 80 percent of the T1 stock, only 80 percent of T1 asset basis and value should be taken into account in calculating T's ADSP. By taking into account 80 percent of these amounts, the remaining calculations and results are the same as in paragraphs (ii), (iii), (iv), and (v) of this Example 4, except that the grossed-up amount realized on the sale of the recently purchased T1 stock is \$44,455.00 (\$35,564.00/0.8).

(h) *Deemed sale of target affiliate stock*—(1) *Scope*. This paragraph (h) prescribes rules relating to the treatment of gain or loss realized on the deemed sale of stock of a target affiliate when a section 338 election (but not a section 338(h)(10) election) is made for the target affiliate. For purposes of this paragraph (h), the definition of domestic corporation in §1.338-2(c)(9) is applied without the exclusion therein for DISCs, corporations described in section 1248(e), and corporations to which an election under section 936 applies.

(2) *In general*. Except as otherwise provided in this paragraph (h), if a section 338 election is made for target, target rec-

ognizes no gain or loss on the deemed sale of stock of a target affiliate having the same acquisition date and for which a section 338 election is made if—

(i) Target directly owns stock in the target affiliate satisfying the requirements of section 1504(a)(2);

(ii) Target and the target affiliate are members of a consolidated group filing a final consolidated return described in §1.338–10(a)(1); or

(iii) Target and the target affiliate file a combined return under §1.338–10(a)(4).

(3) *Deemed sale of foreign target affiliate by a domestic target.* A domestic target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate. For the proper treatment of such gain or loss, see, e.g., sections 1246, 1248, 1291 et seq., and 338(h)(16) and §1.338–9.

(4) *Deemed sale producing effectively connected income.* A foreign target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate to the extent that such gain or loss is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(5) *Deemed sale of insurance company target affiliate electing under section 953(d).* A domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that has in effect an election under section 953(d) in an amount equal to the lesser of the gain realized or the earnings and profits described in section 953(d)(4)(B).

(6) *Deemed sale of DISC target affiliate.* A foreign or domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that is a DISC or a former DISC (as defined in section 992(a)) in an amount equal to the lesser of the gain realized or the amount of accumulated DISC income determined with respect to such stock under section 995(c). Such gain is included in gross income as a dividend as provided in sections 995(c)(2) and 996(g).

(7) *Anti-stuffing rule.* If an asset the adjusted basis of which exceeds its fair market value is contributed or transferred to a target affiliate as transferred basis property (within the meaning of section 7701(a)(43)) and a purpose of such transaction is to reduce the gain (or increase the loss) recognized on the deemed sale of such target affiliate's stock, the gain or

loss recognized by target on the deemed sale of stock of the target affiliate is determined as if such asset had not been contributed or transferred.

(8) *Examples.* The following examples illustrate this paragraph (h):

*Example 1.* (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T's sole asset, all of the T1 stock, has a basis of \$50 and a fair market value of \$150. T's deemed purchase of the T1 stock results in a qualified stock purchase of T1 and a section 338 election is made for T1. T1's assets have a basis of \$50 and a fair market value of \$150.

(ii) T realizes \$100 of gain on the deemed sale of the T1 stock, but the gain is not recognized because T directly owns stock in T1 satisfying the requirements of section 1504(a)(2) and a section 338 election is made for T1.

(iii) T1 recognizes gain of \$100 on the deemed sale of its assets.

*Example 2.* The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the \$100 gain realized by T on the deemed sale of the T1 stock is recognized.

*Example 3.* (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T owns all of the stock of T1 and T2. T's deemed purchase of the T1 and T2 stock results in a qualified stock purchase of T1 and T2 and section 338 elections are made for T1 and T2. T1 and T2 each own 50 percent of the vote and value of T3 stock. The deemed purchases by T1 and T2 of the T3 stock result in a qualified stock purchase of T3 and a section 338 election is made for T3. T is the common parent of a consolidated group and all of the deemed asset sales are reported on the T group's final consolidated return. See §1.338–10(a)(1).

(ii) Because T, T1, T2 and T3 are members of a consolidated group filing a final consolidated return, no gain or loss is recognized by T, T1 or T2 on their respective deemed sales of target affiliate stock.

*Example 4.* (i) T's sole asset, all of the FT1 stock, has a basis of \$25 and a fair market value of \$150. FT1's sole asset, all of the FT2 stock, has a basis of \$75 and a fair market value of \$150. FT1 and FT2 each have \$50 of accumulated earnings and profits for purposes of section 1248(c) and (d). FT2's assets have a basis of \$125 and a fair market value of \$150, and their sale would not generate subpart F income under section 951. The sale of the FT2 stock or assets would not generate income effectively connected with the conduct of a trade or business within the United States. FT1 does not have an election in effect under section 953(d) and neither FT1 nor FT2 is a passive foreign investment company.

(ii) P makes a qualified stock purchase of T and makes a section 338 election for T. T's deemed purchase of the FT1 stock results in a qualified stock purchase of FT1 and a section 338 election is made for FT1. Similarly, FT1's deemed purchase of the FT2 stock results in a qualified stock purchase of FT2 and a section 338 election is made for FT2.

(iii) T recognizes \$125 of gain on the deemed sale of the FT1 stock under paragraph (h)(3) of this section. FT1 does not recognize \$75 of gain on the

deemed sale of the FT2 stock under paragraph (h)(2) of this section. FT2 recognizes \$25 of gain on the deemed sale of its assets. The \$125 gain T recognizes on the deemed sale of the FT1 stock is included in T's income as a dividend under section 1248, because FT1 and FT2 have sufficient earnings and profits for full recharacterization (\$50 of accumulated earnings and profits in FT1, \$50 of accumulated earnings and profits in FT2), and \$25 of deemed sale earnings and profits in FT2). §1.338–9(b). For purposes of sections 901 through 908, the source and foreign tax credit limitation basket of \$25 of the recharacterized gain on the deemed sale of the FT1 stock is determined under section 338(h)(16).

#### §1.338–5 Adjusted grossed-up basis.

(a) *Scope.* This section provides rules under section 338(b) to determine the adjusted grossed-up basis (AGUB) for target. AGUB is the amount for which new target is deemed to have purchased all of its assets in the deemed purchase under section 338(a)(2). AGUB is allocated among target's assets in accordance with §1.338–6 to determine the price at which the assets are deemed to have been purchased. When an increase or decrease with respect to an element of AGUB is required, under general principles of tax law, after the close of new target's first taxable year, redetermined AGUB is allocated among target's assets in accordance with §1.338–7.

(b) *Determination of AGUB—(1) General rule.* AGUB is the sum of—

(i) The grossed-up basis in the purchasing corporation's recently purchased target stock;

(ii) The purchasing corporation's basis in nonrecently purchased target stock; and

(iii) The liabilities of new target.

(2) *Time and amount of AGUB—(i) Original determination.* AGUB is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of AGUB.

(ii) *Redetermination of AGUB.* AGUB is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, with respect to an element of AGUB. For example, AGUB is redetermined because of an increase or decrease in the amount paid or incurred for recently purchased stock or nonrecently purchased stock or because liabilities not originally taken into account in determining AGUB are subsequently taken into ac-



count. An increase or decrease to an element of ADSP may cause an increase or decrease to an element of AGUB. For example, if an increase in the amount realized for recently purchased stock of target is taken into account after the acquisition date, any increase in tax liability of target for the deemed sale gain is also taken into account when AGUB is redetermined. An increase or decrease to one element of AGUB may also cause an increase or decrease to another element of AGUB. For example, if there is an increase in the amount paid or incurred for recently purchased stock after the acquisition date, any increase in the basis of nonrecently purchased stock because a gain recognition election was made is also taken into account when AGUB is redetermined. Increases or decreases with respect to the elements of AGUB that are taken into account before the close of new target's first taxable year are taken into account for purposes of determining AGUB and the basis of target's assets as if they had been taken into account at the beginning of the day after the acquisition date. Increases or decreases with respect to the elements of AGUB that are taken into account after the close of new target's first taxable year result in the reallocation of AGUB among target's assets under §1.338-7.

(iii) *Examples.* The following examples illustrate this paragraph (b)(2):

*Example 1.* In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of \$100,000. P acquires all of the stock of T in Year 3 for \$700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to \$80,000. Assume that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its basis. Accordingly, AGUB is redetermined at the time of the reduction. See paragraph (e)(2) of this section. Thus the purchase price reduction affects the basis of the truck only indirectly, through the mechanism of §§1.338-6 and 1.338-7. See §1.338-4(b)(2)(iii) *Example* for the effect on ADSP.

*Example 2.* T, an accrual basis taxpayer, is a chemical manufacturer. In Year 1, T is obligated to remediate environmental contamination at the site of one of its plants. Assume that all the events have occurred that establish the fact of the liability and the

amount of the liability can be determined with reasonable accuracy but economic performance has not occurred with respect to the liability within the meaning of section 461(h). P acquires all of the stock of T in Year 1 and makes a section 338 election for T. Assume that, if a corporation unrelated to T had actually purchased T's assets and assumed T's obligation to remediate the contamination, the corporation would not satisfy the economic performance requirements until Year 5. Under section 461(h), the assumed liability would not be treated as incurred and taken into account in basis until that time. The incurrence of the liability in Year 5 under the economic performance rules is an increase in the amount of liabilities properly taken into account in basis and results in the redetermination of AGUB. (Respecting ADSP, compare §1.461-4(d)(5), which provides that economic performance occurs for old T as the amount of the liability is properly taken into account in amount realized on the deemed asset sale. Thus ADSP is not redetermined when new T satisfies the economic performance requirements.)

(c) *Grossed-up basis of recently purchased stock.* The purchasing corporation's grossed-up basis of recently purchased target stock (as defined in section 338(b)(6)(A)) is an amount equal to—

(1) The purchasing corporation's basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs taken into account in paragraph (c)(3) of this section;

(2) Multiplied by a fraction, the numerator of which is 100 percent minus the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock, and the denominator of which is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's recently purchased target stock;

(3) Plus the acquisition costs the purchasing corporation incurred in connection with its purchase of the recently purchased stock that are capitalized in the basis of such stock (e.g., brokerage commissions and any similar costs incurred by the purchasing corporation to acquire the stock).

(d) *Basis of nonrecently purchased stock; gain recognition election—(1) No gain recognition election.* In the absence of a gain recognition election under section 338(b)(3) and this section, the purchasing corporation retains its basis in the nonrecently purchased stock.

(2) *Procedure for making gain recognition election.* A gain recognition election

may be made for nonrecently purchased stock of target (or a target affiliate) only if a section 338 election is made for target (or the target affiliate). The gain recognition election is made by attaching a gain recognition statement to a timely filed Form 8023 for target. The gain recognition statement must contain the information specified in the form and its instructions. The gain recognition election is irrevocable. If a section 338(h)(10) election is made for target, see §1.338(h)(10)-1(d)(1) (providing that the purchasing corporation is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock).

(3) *Effect of gain recognition election—(i) In general.* If the purchasing corporation makes a gain recognition election, then for all purposes of the Internal Revenue Code—

(A) The purchasing corporation is treated as if it sold on the acquisition date the nonrecently purchased target stock for the basis amount determined under paragraph (d)(3)(ii) of this section; and

(B) The purchasing corporation's basis on the acquisition date in nonrecently purchased target stock immediately following the deemed sale in paragraph (d)(3)(i)(A) of this section is the basis amount.

(ii) *Basis amount.* The basis amount is equal to the amount in paragraph (c)(1) of this section (the purchasing corporation's basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs taken into account in paragraph (c)(3) of this section) multiplied by a fraction the numerator of which is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock and the denominator of which is 100 percent minus the numerator amount. Thus, if target has a single class of outstanding stock, the purchasing corporation's basis in each share of nonrecently purchased target stock after the gain recognition election is equal to the average price per share of the purchasing corporation's recently purchased target stock.

(iii) *Losses not recognized.* Only gains (unreduced by losses) on the nonrecently purchased target stock are recognized.

(iv) *Stock subject to election.* The gain recognition election applies to—

(A) All nonrecently purchased target stock; and

(B) Any nonrecently purchased stock in a target affiliate having the same acquisition date as target if such target affiliate stock is held by the purchasing corporation on such date.

(e) *Liabilities of new target*—(1) *In general.* The liabilities of new target are the liabilities of target (and the liabilities to which target's assets are subject) as of the beginning of the day after the acquisition date (other than liabilities that were neither liabilities of old target nor liabilities to which old target's assets were subject). In order to be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in basis under general principles of tax law that would apply if new target had acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liability. See §1.338-4(d)(1) for examples of when tax liabilities are considered liabilities assumed by new target.

(2) *Time and amount of liabilities.* The time for taking into account liabilities of old target in determining AGUB and the amount of the liabilities taken into account is determined as if new target had

acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liabilities. For example, an increase or decrease in a liability that does not affect the amount of new target's basis arising from the assumption of, or taking subject to, the liability is not taken into account in redetermining AGUB.

(3) *Interaction with deemed sale gain.* See §1.338-4(d)(3).

(f) *Adjustments by the Internal Revenue Service.* In connection with the examination of a return, the District Director may increase (or decrease) AGUB under the authority of section 338(b)(2) and allocate such amounts to target's assets under the authority of section 338(b)(5) so that AGUB and the basis of target's assets properly reflect the cost to the purchasing corporation of its interest in target's assets. Such items may include distributions from target to the purchasing corporation, capital contributions from the purchasing corporation to target during the 12-month acquisition period, or acquisitions of target stock by the purchasing corporation after the acquisition date from minority shareholders.

(g) *Examples.* The following examples illustrate this section. For purposes of the

examples in this paragraph (g), T has no liabilities other than the tax liability for the deemed sale gain, T shareholders incur no costs in selling the T stock, and P incurs no costs in acquiring the T stock. The examples are as follows:

*Example 1.* (i) Before July 1 of Year 1, P purchases 10 of the 100 shares of T stock for \$5,000. On July 1 of Year 2, P purchases 80 shares of T stock for \$60,000 and makes a section 338 election for T. As of July 1 of Year 2, T's only asset is raw land with an adjusted basis to T of \$50,400 and a fair market value of \$100,000. T has no loss or tax credit carryovers to Year 2. T's marginal tax rate for any ordinary income or net capital gain resulting from the deemed asset sale is 34 percent. The 10 shares purchased before July 1 of Year 1 constitute nonrecently purchased T stock with respect to P's qualified stock purchase of T stock on July 1 of Year 2.

(ii) The ADSP formula as applied to these facts is the same as in §1.338-4(g) *Example 1*. Accordingly, the ADSP for T is \$87,672.72. The existence of nonrecently purchased T stock is irrelevant for purposes of the ADSP formula, because that formula treats P's nonrecently purchased T stock in the same manner as T stock not held by P.

(iii) The total tax liability resulting from T's deemed asset sale, as calculated under the ADSP formula, is \$12,672.72.

(iv) If P does not make a gain recognition election, the AGUB of new T's assets is \$85,172.72, determined as follows (In the following formula, GRP is the grossed-up basis in P's recently purchased T stock, BNP is P's basis in nonrecently purchased T stock, L is T's liabilities, and X is P's acquisition costs for the recently purchased T stock):

$$\text{AGUB} = \text{GRP} + \text{BNP} + \text{L} + \text{X}$$

$$\text{AGUB} = \$60,000 \times [(1 - .1)/.8] + \$5,000 + \$12,672.72 + 0$$

$$\text{AGUB} = \$85,172.72$$

(v) If P makes a gain recognition election, the AGUB of new T's assets is \$87,672.72, determined as follows:

$$\text{AGUB} = \$60,000 \times [(1 - .1)/.8] + \$60,000 \times [(1 - .1)/.8] \times [.1/(1 - .1)] + \$12,672.72$$

$$\text{AGUB} = \$87,672.72$$

(vi) The calculation of AGUB if P makes a gain recognition election may be simplified as follows:

$$\text{AGUB} = \$60,000/.8 + \$12,672.72$$

$$\text{AGUB} = \$87,672.72$$

(vii) As a result of the gain recognition election, P's basis in its nonrecently purchased T stock is increased from \$5,000 to \$7,500 (i.e., \$60,000  $\times$   $[(1 - .1)/.8] \times [.1/(1 - .1)]$ ). Thus, P recognizes a gain in Year 2 with respect to its nonrecently purchased T stock of \$2,500 (i.e., \$7,500 - \$5,000).

*Example 2.* On January 1 of Year 1, P purchases one-third of the T stock. On March 1 of Year 1, T distributes a dividend to all of its shareholders. On April 15 of Year 1, P purchases the remaining T stock and makes a section 338 election for T. In appropriate circumstances, the District Director may decrease the AGUB of T to take into account the payment of the dividend and properly reflect the fair market value of T's assets deemed purchased.

*Example 3.* (i) T's sole asset is a building worth

\$100,000. At this time, T has 100 shares of stock outstanding. On August 1 of Year 1, P purchases 10 of the 100 shares of T stock for \$8,000. On June 1 of Year 2, P purchases 50 shares of T stock for \$50,000. On June 15 of Year 2, P contributes a tract of land to the capital of T and receives 10 additional shares of T stock as a result of the contribution. Both the basis and fair market value of the land at that time are \$10,800. On June 30 of Year 2, P purchases the remaining 40 shares of T stock for \$40,000 and makes a section 338 election for T. The AGUB of T is \$108,800.

(ii) To prevent the shifting of basis from the contributed property to other assets of T, the District Director may allocate \$10,800 of the AGUB to the land, leaving \$98,000 to be allocated to the building. See paragraph (f) of this section. Otherwise, applying the allocation rules of §1.338-6 would, on these facts, result in an allocation to the recently contributed land of an amount less than its value of \$10,800, with the difference being allocated to the building already held by T.

Par. 5. Sections 1.338-6 and 1.338-7 are added to read as follows:

### *§1.338-6 Allocation of ADSP and AGUB among target assets.*

(a) *Scope*—(1) *In general.* This section prescribes rules for allocating ADSP and AGUB among the acquisition date assets of a target for which a section 338 election is made.

(2) *Fair market value*—(i) *In general.* Generally, the fair market value of an asset is its gross fair market value (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities). However, for purposes of determining the amount of old target's deemed sale gain, the fair market value of any property

subject to a nonrecourse indebtedness will be treated as being not less than the amount of such indebtedness. (For purposes of the preceding sentence, a liability that was incurred because of the acquisition of the property is disregarded to the extent that such liability was not taken into account in determining old target's basis in such property.)

(ii) *Transaction costs.* Transaction costs are not taken into account in allocating ADSP or AGUB to assets in the deemed sale (except indirectly through their effect on the total ADSP or AGUB to be allocated).

(iii) *Internal Revenue Service authority.* In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties. For example, in certain cases the Internal Revenue Service may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer's valuation of other assets.

(b) *General rule for allocating ADSP and AGUB—*(1) *Reduction in the amount of consideration for Class I assets.* Both ADSP and AGUB, in the respective allocation of each, are first reduced by the amount of Class I acquisition date assets. Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions. If the amount of Class I assets exceeds AGUB, new target will immediately realize ordinary income in an amount equal to such excess. The amount of ADSP or AGUB remaining after the reduction is to be allocated to the remaining acquisition date assets.

(2) *Other assets—*(i) *In general.* Subject to the limitations and other rules of paragraph (c) of this section, ADSP and AGUB (as reduced by the amount of Class I assets) are allocated among Class II acquisition date assets of target in proportion to the fair market values of such Class II assets at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, then among Class V as-

sets so held in such proportion, then among Class VI assets so held in such proportion, and finally to Class VII assets.

(ii) *Class II assets.* Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and §1.1092(d)-1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Examples of Class II assets include U.S. government securities and publicly traded stock.

(iii) *Class III assets.* Class III assets are accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business.

(iv) *Class IV assets.* Class IV assets are stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(v) *Class V assets.* Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.

(vi) *Class VI assets.* Class VI assets are all section 197 intangibles, as defined in section 197, except goodwill and going concern value.

(vii) *Class VII assets.* Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

(3) *Other items designated by the Internal Revenue Service.* Similar items may be added to any class described in this paragraph (b) by designation in the Internal Revenue Bulletin by the Internal Revenue Service.

(c) *Certain limitations and other rules for allocation to an asset—*(1) *Allocation not to exceed fair market value.* The amount of ADSP or AGUB allocated to an asset (other than Class VII assets) cannot exceed the fair market value of that asset at the beginning of the day after the acquisition date.

(2) *Allocation subject to other rules.* The amount of ADSP or AGUB allocated to an asset is subject to other provisions of the Internal Revenue Code or general principles of tax law in the same manner as if such asset were transferred to or acquired from an unrelated person in a sale

or exchange. For example, if the deemed asset sale is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of AGUB allocated to a contract for the services of an athlete cannot exceed the limitation imposed by that section. As another example, the amount of AGUB allocated to an amortizable section 197 intangible resulting from an assumption-reinsurance transaction is determined under section 197(f)(5).

(3) *Special rule for allocating AGUB when purchasing corporation has nonrecently purchased stock—*(i) *Scope.* This paragraph (c)(3) applies if at the beginning of the day after the acquisition date—

(A) The purchasing corporation holds nonrecently purchased stock for which a gain recognition election under section 338(b)(3) and §1.338-5(d) is not made; and

(B) The hypothetical purchase price determined under paragraph (c)(3)(ii) of this section exceeds the AGUB determined under §1.338-5(b).

(ii) *Determination of hypothetical purchase price.* Hypothetical purchase price is the AGUB that would result if a gain recognition election were made.

(iii) *Allocation of AGUB.* Subject to the limitations in paragraphs (c)(1) and (2) of this section, the portion of AGUB (after reduction by the amount of Class I assets) to be allocated to each Class II, III, IV, V, VI, and VII asset of target held at the beginning of the day after the acquisition date is determined by multiplying—

(A) The amount that would be allocated to such asset under the general rules of this section were AGUB equal to the hypothetical purchase price; by

(B) A fraction, the numerator of which is actual AGUB (after reduction by the amount of Class I assets) and the denominator of which is the hypothetical purchase price (after reduction by the amount of Class I assets).

(4) *Liabilities taken into account in determining amount realized on subsequent disposition.* In determining the amount realized on a subsequent sale or other disposition of property deemed purchased by new target, the entire amount of any liability taken into account in AGUB is considered to be an amount taken into account in determining new target's basis in



property that secures the liability for purposes of applying §1.1001-2(a). Thus, if a liability is taken into account in AGUB, §1.1001-2(a)(3) does not prevent the amount of such liability from being treated as discharged within the meaning of §1.1001-2(a)(4) as a result of new target's sale or disposition of the property which secures such liability.

(d) *Examples.* The following examples illustrate §§1.338-4, 1.338-5, and this section:

Example 1. (i) T owns 90 percent of the outstanding T1 stock. P purchases 100 percent of the outstanding T stock for \$2,000. There are no acquisition costs. P makes a section 338 election for T and, as a result, T1 is considered acquired in a qualified stock purchase. A section 338 election is made for T1. The grossed-up basis of the T stock is \$2,000 (i.e., \$2,000 (1/1)).

(ii) The liabilities of T as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale gain) that would, under general principles of tax law, be properly taken into account before the close of new T's first taxable year, are as follows:

Liabilities (nonrecourse mortgage plus unsecured liabilities) .....	\$ 700
Taxes Payable .....	<u>300</u>
Total .....	\$ 1,000

(iii) The AGUB of T is determined as follows:

Grossed-up basis .....	\$2,000
Total liabilities .....	<u>1,000</u>
AGUB .....	\$ 3,000

(iv) Assume that ADSP is also \$3,000.

(v) Assume that, at the beginning of the day after the acquisition date, T's cash and the fair market values of T's Class II, III, IV, and V assets are as follows:

Asset Class	Asset	Fair market value
I	Cash .....	\$ 200*
II	Portfolio of actively traded securities .....	300
III	Accounts receivable .....	600
IV	Inventory .....	300
V	Building .....	800
V	Land .....	200
V	Investment in T1 .....	<u>450</u>
	Total .....	\$ 2,850

\*Amount

(vi) Under paragraph (b)(1) of this section, the amount of ADSP and AGUB allocable to T's Class II, III, IV, and V assets is reduced by the amount of cash to \$2,800, i.e., \$3,000 - \$200. \$300 of ADSP and of AGUB is then allocated to actively traded securities. \$600 of ADSP and of AGUB is then allocated to accounts receivable. \$300 of ADSP and of AGUB is then allocated to the inventory. Since the remaining amount of ADSP and of AGUB is \$1,600 (i.e., \$3,000 - (\$200 + \$300 + \$600 + \$300)), an amount which exceeds the sum of the fair market

values of T's Class V assets, the amount of ADSP and of AGUB allocated to each Class V asset is its fair market value:

Building .....	800
Land .....	200
Investment in T1 .....	<u>450</u>
Total .....	\$ 1,450

(vii) T has no Class VI assets. The amount of ADSP and of AGUB allocated to T's Class VII assets (goodwill and going concern value) is \$150, i.e., \$1,600 - \$1,450.

(viii) The grossed-up basis of the T1 stock is \$500, i.e., \$450 (1/.9).

(ix) The liabilities of T as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale gain) that would, under general principles of tax law, be properly taken into account before the close of new T's first taxable year, are as follows:

General Liabilities .....	\$ 100
Taxes Payable .....	<u>20</u>
Total .....	\$ 120

(x) The AGUB of T1 is determined as follows:

Grossed-up basis of T1 Stock .....	\$ 500
Liabilities .....	<u>120</u>
AGUB .....	\$ 620

(xi) Assume that ADSP is also \$620.

(xii) Assume that at the beginning of the day after the acquisition date, T1's cash and the fair market values of its Class IV and VI assets are as follows:

Asset Class	Asset	Fair market value
I	Cash .....	\$ 50*
IV	Inventory .....	200
VI	Patent .....	<u>350</u>
	Total .....	\$ 600

\*Amount

(xiii) The amount of ADSP and of AGUB allocable to T1's Class IV and VI assets is first reduced by the \$50 of cash.

(xiv) Because the remaining amount of ADSP and of AGUB (\$570) is an amount which exceeds the fair market value of T1's only Class IV asset, the inventory, the amount allocated to the inventory is its fair market value (\$200). After that, the remaining amount of ADSP and of AGUB (\$370) exceeds the fair market value of T1's only Class VI asset, the patent. Thus, the amount of ADSP and of AGUB allocated to the patent is its fair market value (\$350).

(xv) The amount of ADSP and of AGUB allocated to T1's Class VII assets (goodwill and going concern value) is \$20, i.e., \$570 - \$550.

Example 2. (i) Assume that the facts are the same as in Example 1 except that P has, for five years, owned 20 percent of T's stock, which has a basis in P's hands at the beginning of the day after the acquisition date of \$100, and P purchases the remaining 80 percent of T's stock for \$1,600. P does not make a gain recognition election under section 338(b)(3).

(ii) Under §1.338-5(c), the grossed-up basis of recently purchased T stock is \$1,600, i.e., \$1,600 × (1 - .2)/.8.

(iii) The AGUB of T is determined as follows:

Grossed-up basis of recently purchased stock as determined under

§1.338-5(c) (\$1,600 × (1 - .2)/.8) ....	\$ 1,600
Basis of nonrecently purchased stock ...	100
Liabilities .....	<u>1,000</u>
AGUB .....	\$ 2,700

(iv) Since P holds nonrecently purchased stock, the hypothetical purchase price of the T stock must be computed and is determined as follows:

Grossed-up basis of recently purchased stock as determined under

§1.338-5(c) (\$1,600 × (1 - .2)/.8) ....	\$ 1,600
Basis of nonrecently purchased stock as if the gain recognition election under §1.338-5(d)(2) had been made (\$1,600 × .2/(1 - .2)) .....	400
Liabilities .....	<u>1,000</u>
Total .....	\$ 3,000

(v) Since the hypothetical purchase price (\$3,000) exceeds the AGUB (\$2,700) and no gain recognition election is made under section 338(b)(3), AGUB is allocated under paragraph (c)(3) of this section.

(vi) First, an AGUB amount equal to the hypothetical purchase price (\$3,000) is allocated among the assets under the general rules of this section. The allocation is set forth in the column below entitled *Original Allocation*. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction having a numerator equal to the actual AGUB reduced by the amount of Class I assets (\$2,700 - \$200 = \$2,500) and a denominator equal to the hypothetical purchase price reduced by the amount of Class I assets (\$3,000 - \$200 = \$2,800), or 2,500/2,800. This produces the *Final Allocation*:

Class	Asset	Original Allocation	Final Allocation
I	Cash .....	\$ 200	\$ 200
II	Portfolio of actively traded securities	300	268*
III	Accounts receivable	600	536
IV	Inventory .....	300	268
V	Building .....	800	714
V	Land .....	200	178
V	Investment in T1 ..	450	402
VII	Goodwill and going concern value ..	<u>150</u>	<u>134</u>
	Total .....	\$ 3,000	\$ 2,700

\* All numbers rounded for convenience.

### §1.338-7 Allocation of redetermined ADSP and AGUB among target assets.

(a) *Scope.* ADSP and AGUB are redetermined at such time and in such amount as an increase or decrease would be required under general principles of tax law for the elements of ADSP or AGUB. This section provides rules for allocating redetermined ADSP or AGUB when increases or decreases with respect to the elements of ADSP or AGUB are required after the close of new target's first taxable year. For determining and allocating ADSP or

AGUB when increases or decreases are required with respect to the elements of ADSP or AGUB before the close of new target's first taxable year, see §§1.338-4, 1.338-5, and 1.338-6.

(b) *Allocation of redetermined ADSP and AGUB.* When ADSP or AGUB is redetermined, a new allocation of ADSP or AGUB is made by allocating the redetermined ADSP or AGUB amount under the rules of §1.338-6. If the allocation of the redetermined ADSP or AGUB amount under §1.338-6 to a given asset is different from the original allocation to it, the difference is added to or subtracted from the original allocation to the asset, as appropriate. Amounts allocable to an acquisition date asset (or with respect to a disposed-of acquisition date asset) are subject to all the asset allocation rules (for example, the fair market value limitation in §1.338-6(c)(1)) as if the redetermined ADSP or AGUB were the ADSP or AGUB on the acquisition date.

(c) *Special rules for ADSP*—(1) *Increases or decreases in deemed sale gain taxable notwithstanding old target ceases to exist.* To the extent general principles of tax law would require a seller in an actual asset sale to account for events relating to the sale that occur after the sale date, target must make such an accounting. Target is not precluded from realizing additional deemed sale gain because the target is treated as a new corporation after the acquisition date.

(2) *Procedure for transactions in which section 338(h)(10) is not elected*—(i) *Deemed sale gain included in new target's return.* If an election under section 338(h)(10) is not made, any additional deemed sale gain of old target resulting from an increase or decrease in the ADSP is included in new target's income tax return for new target's taxable year in which the increase or decrease is taken into account. For example, if after the acquisition date there is an increase in the allocable ADSP of section 1245 property for which the recomputed basis (but not the adjusted basis) exceeds the portion of the ADSP allocable to that particular asset on the acquisition date, the additional gain is treated as ordinary income to the extent it does not exceed such excess amount. See paragraph (c)(2)(ii) of this section for the special treatment of old target's carryovers and carrybacks. Although included

in new target's income tax return, the deemed sale gain is separately accounted for as an item of old target and may not be offset by income, gain, deduction, loss, credit, or other amount of new target. The amount of tax on income of old target resulting from an increase or decrease in the ADSP is determined as if such deemed sale gain had been recognized in old target's taxable year ending at the close of the acquisition date.

(ii) *Carryovers and carrybacks*—(A) *Loss carryovers to new target taxable years.* A net operating loss or net capital loss of old target may be carried forward to a taxable year of new target, under the principles of section 172 or 1212, as applicable, but is allowed as a deduction only to the extent of any recognized income of old target for such taxable year, as described in paragraph (c)(2)(i) of this section. For this purpose, however, taxable years of new target are not taken into account in applying the limitations in section 172(b)(1) or 1212(a)(1)(B) (or other similar limitations). In applying sections 172(b) and 1212(a)(1), only income, gain, loss, deduction, credit, and other amounts of old target are taken into account. Thus, if old target has an unexpired net operating loss at the close of its taxable year in which the deemed asset sale occurred that could be carried forward to a subsequent taxable year, such loss may be carried forward until it is absorbed by old target's income.

(B) *Loss carrybacks to taxable years of old target.* An ordinary loss or capital loss accounted for as a separate item of old target under paragraph (c)(2)(i) of this section may be carried back to a taxable year of old target under the principles of section 172 or 1212, as applicable. For this purpose, taxable years of new target are not taken into account in applying the limitations in section 172(b) or 1212(a) (or other similar limitations).

(C) *Credit carryovers and carrybacks.* The principles described in paragraphs (c)(2)(ii)(A) and (B) of this section apply to carryovers and carrybacks of amounts for purposes of determining the amount of a credit allowable under part IV, subchapter A, chapter 1 of the Internal Revenue Code. Thus, for example, credit carryovers of old target may offset only income tax attributable to items described in paragraph (c)(2)(i) of this section.

(3) *Procedure for transactions in which section 338(h)(10) is elected.* If an election under section 338(h)(10) is made, any additional deemed sale gain resulting from an increase or decrease in the ADSP is accounted for in determining the taxable income (or other amount) of the member of the selling consolidated group, the selling affiliate, or the S corporation shareholders to which such income, loss, or other amount is attributable for the taxable year in which such increase or decrease is taken into account.

(d) *Special rules for AGUB*—(1) *Effect of disposition or depreciation of acquisition date assets.* If an acquisition date asset has been disposed of, depreciated, amortized, or depleted by new target before an amount is added to the original allocation to the asset, the increased amount otherwise allocable to such asset is taken into account under general principles of tax law that apply when part of the cost of an asset not previously taken into account in basis is paid or incurred after the asset has been disposed of, depreciated, amortized, or depleted. A similar rule applies when an amount is subtracted from the original allocation to the asset. For purposes of the preceding sentence, an asset is considered to have been disposed of to the extent that its allocable portion of the decrease in AGUB would reduce its basis below zero.

(2) *Section 38 property.* Section 1.47-2(c) applies to a reduction in basis of section 38 property under this section.

(e) *Examples.* The following examples illustrate this section. Any amount described in the following examples is exclusive of interest. For rules characterizing deferred contingent payments as principal or interest, see §§1.483-4, 1.1274-2(g), and 1.1275-4(c). The examples are as follows:

*Example 1.* (i)(A) T's assets other than goodwill and going concern value, and their fair market values at the beginning of the day after the acquisition date, are as follows:

Asset Class	Asset	Fair Market Value
V	Building . . . . .	\$ 100
V	Stock of X (not a target) . . . . .	<u>200</u>
	Total . . . . .	\$ 300

(B) T has no liabilities other than a contingent liability that would not be taken into account under general principles of tax law in an asset sale between

unrelated parties when the buyer assumed the liability or took property subject to it.

(ii)(A) On September 1, 2000, P purchases all of the outstanding stock of T for \$270 and makes a section 338 election for T. The grossed-up basis of the T stock and T's AGUB are both \$270. The AGUB is ratably allocated among T's Class V assets in proportion to their fair market values as follows:

Asset	Basis
Building (\$270 ( 100/300) ) . . . . .	\$ 90
Stock (\$270 ( 200/300) ) . . . . .	<u>180</u>
Total . . . . .	\$270

Asset	Original AGUB	Redetermined AGUB	Increase
Building . . . . .	\$ 90	\$ 100	\$ 10
X Stock . . . . .	180	200	20
Goodwill and going concern value . . . . .	<u>0</u>	<u>30</u>	<u>30</u>
Total . . . . .	\$ 270	\$ 330	\$ 60

(vi) Since the X stock was disposed of before the contingent liability was properly taken into account for tax purposes, no amount of the increase in AGUB attributable to such stock may be allocated to any T asset. Rather, such amount (\$20) is allowed as a capital loss to T for the taxable year 2002 under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). In addition, the \$10 increase in AGUB allocated to the building and the \$30 increase in AGUB allocated to the goodwill and going concern value are treated as basis redeterminations in 2002. See paragraph (d)(1) of this section.

**Example 2.** (i) On January 1, 2002, P purchases all of the outstanding stock of T and makes a section 338 election for T. Assume that ADSP and AGUB of T are both \$500 and are allocated among T's acquisition date assets as follows:

Class	Asset	Basis
V	Machinery . . . . .	\$ 150
V	Land . . . . .	250
VII	Goodwill and going concern value . . . . .	<u>100</u>
	Total . . . . .	\$ 500

(ii) On September 30, 2004, P filed a claim against the selling shareholders of T in a court of appropriate jurisdiction alleging fraud in the sale of the T stock.

(iii) On January 1, 2007, the former shareholders refund \$140 of the purchase price to P in a settlement of the lawsuit. Assume that, under general principles of tax law, both the seller and the buyer properly take into account such refund when paid. Assume also that the refund has no effect on the tax liability for the deemed sale gain. This refund results in a decrease of T's ADSP and AGUB of \$140, from \$500 to \$360.

(iv) The redetermined ADSP and AGUB of \$360 is allocated among T's acquisition date assets. Because ADSP and AGUB do not exceed the fair market value of the Class V assets, the ADSP and AGUB amounts are allocated to the Class V assets in proportion to their fair market values at the beginning of the day after the acquisition date. Thus,

(B) No amount is allocated to the Class VII assets. New T is a calendar year taxpayer. Assume that the X stock is a capital asset in the hands of new T.

(iii) On January 1, 2001, new T sells the X stock and uses the proceeds to purchase inventory.

(iv) Pursuant to events on June 30, 2002, the contingent liability of old T is at that time properly taken into account under general principles of tax law. The amount of the liability is \$60.

(v) T's AGUB increases by \$60 from \$270 to \$330. This \$60 increase in AGUB is first allocated among T's acquisition date assets in accordance with

\$135 ( $\$150 \times (\$360/(\$150 + \$250))$ ) is allocated to the machinery and \$225 ( $\$250 \times (\$360/(\$150 + \$250))$ ) is allocated to the land. Accordingly, the basis of the machinery is reduced by \$15 (\$150 original allocation - \$135 redetermined allocation) and the basis of the land is reduced by \$25 (\$250 original allocation - \$225 redetermined allocation). No amount is allocated to the Class VII assets. Accordingly, the basis of the goodwill and going concern value is reduced by \$100 (\$100 original allocation - \$0 redetermined allocation).

(v) Assume that, as a result of deductions under section 168, the adjusted basis of the machinery immediately before the decrease in AGUB is zero. The machinery is treated as if it were disposed of before the decrease is taken into account. In 2007, T recognizes income of \$15, the character of which is determined under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), and the tax benefit rule. No adjustment to the basis of T's assets is made for any tax paid on this amount. Assume also that, as a result of amortization deductions, the adjusted basis of the goodwill and going concern value immediately before the decrease in AGUB is \$40. A similar adjustment to income is made in 2007 with respect to the \$60 of previously amortized goodwill and going concern value.

(vi) In summary, the basis of T's acquisition date assets, as of January 1, 2007, is as follows:

Asset	Basis
Machinery . . . . .	\$ 0
Land . . . . .	225
Goodwill and going concern value . . . . .	0

**Example 3.** (i) Assume that the facts are the same as §1.338-6(d) *Example 2* except that the recently purchased stock is acquired for \$1,600 plus additional payments that are contingent upon T's future earnings. Assume that, under general principles of tax law, such later payments are properly taken into account when paid. Thus, T's AGUB, determined as of the beginning of the day after the acquisition date (after reduction by T's cash of \$200), is \$2,500 and is allocated among T's acquisition date assets under §1.338-6(c)(3)(iii) as follows:

the provisions of §1.338-6. Because the redetermined AGUB for T (\$330) exceeds the sum of the fair market values at the beginning of the day after the acquisition date of the Class V acquisition date assets (\$300), AGUB allocated to those assets is limited to those fair market values under §1.338-6(c)(1). As there are no Class VI assets, the remaining AGUB of \$30 is allocated to goodwill and going concern value (Class VII assets). The amount of increase in AGUB allocated to each acquisition date asset is determined as follows:

Class	Asset	Final Allocation
I	Cash . . . . .	\$ 200
II	Portfolio of actively traded securities . . . . .	268*
III	Accounts receivable . . . . .	536
IV	Inventory . . . . .	268
V	Building . . . . .	714
V	Land . . . . .	178
V	Investment in T1 . . . . .	402
VII	Goodwill and going concern value . . . . .	<u>134</u>
	Total . . . . .	\$ 2,700

\* All numbers rounded for convenience.

(ii) After the close of new target's first taxable year, P pays an additional \$200 for its recently purchased T stock. Assume that the additional consideration paid would not increase T's tax liability for the deemed sale gain.

(iii) T's AGUB increases by \$200, from \$2,700 to \$2,900. This \$200 increase in AGUB is accounted for in accordance with the provisions of §1.338-6(c)(3)(iii).

(iv) The hypothetical purchase price of the T stock is redetermined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338-5(c) ( $\$1,800 \times (1 - .2)/.8$ ) . . . . .	\$ 1,800
Basis of nonrecently purchased stock as if the gain recognition election under §1.338-5(d)(2) had been made ( $\$1,800 \times .2/(1 - .2)$ ) . . . . .	450
Liabilities . . . . .	<u>1,000</u>
Total . . . . .	\$ 3,250

(v) Since the redetermined hypothetical purchase price (\$3,250) exceeds the redetermined AGUB (\$2,900) and no gain recognition election was made under section 338(b)(3), the rules of §1.338-6(c)(3)(iii) are reapplied using the redetermined hypothetical purchase price and the redetermined AGUB.

(vi) First, an AGUB amount equal to the redetermined hypothetical purchase price (\$3,250) is allo-



cated among the assets under the general rules of §1.338-6. The allocation is set forth in the column below entitled *Hypothetical Allocation*. Next, the allocation to each asset in Class II through Class VII

is multiplied by a fraction with a numerator equal to the actual redetermined AGUB reduced by the amount of Class I assets (\$2,900 – \$200 = \$2,700) and a denominator equal to the redetermined hypo-

thetical purchase price reduced by the amount of Class I assets (\$3,250 – \$200 = \$3,050), or 2,700/3,050. This produces the *Final Allocation*:

Class	Asset	Hypothetical Allocation	Final Allocation
I	Cash .....	\$ 200	\$ 200
II	Portfolio of actively traded securities .....	300	266*
III	Accounts receivable .....	600	531
IV	Inventory .....	300	266
V	Building .....	800	708
V	Land .....	200	177
V	Investment in T1 .....	450	398
VII	Goodwill and going concern value .....	<u>400</u>	<u>354</u>
	Total .....	\$ 3,250	\$ 2900

\* All numbers rounded for convenience.

(vii) As illustrated by this example, reapplying §1.338-6(c)(3) results in a basis increase for some assets and a basis decrease for other assets. The amount of redetermined AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original (c)(3) allocation	Redetermined (c)(3) allocation	Increase (decrease)
Portfolio of actively traded securities .....	\$ 268	\$ 266	\$ (2)
Accounts receivable .....	536	531	(5)
Inventory .....	268	266	(2)
Building .....	714	708	(6)
Land .....	178	177	(1)
Investment in T1 .....	402	398	(4)
Goodwill and going concern value .....	<u>134</u>	<u>354</u>	<u>220</u>
Total .....	\$ 2,500	\$ 2,700	\$ 200

**Example 4.** (i) On January 1, 2001, P purchases all of the outstanding T stock and makes a section 338 election for T. P pays \$700 of cash and promises also to pay a maximum \$300 of contingent consideration at various times in the future. Assume that, under general principles of tax law, such later payments are properly taken into account by P when paid. Assume also, however, that the current fair market value of the contingent payments is reasonably ascertainable. The fair market value of T's assets (other than goodwill and going concern value) as of the beginning of the following day is as follows:

Asset	Fair market value
Class Assets	
V Equipment .....	\$ 200
V Non-actively traded securities ..	100
V Building .....	<u>500</u>
Total .....	800

(ii) T has no liabilities. The AGUB is \$700. In calculating ADSP, assume that, under §1.1001-1, the current amount realized attributable to the contingent consideration is \$200. ADSP is therefore \$900 (\$700 cash plus \$200).

(iii) (A) The AGUB of \$700 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

Asset	Basis
Equipment (\$700 × 200/800) .....	\$175.00
Non-actively traded securities (\$700 × 100/800) .....	87.50
Building (\$700 × 500/800) .....	<u>437.50</u>
Total .....	\$700.00

(B) No amount is allocated to goodwill or going concern value.

(iv) (A) The ADSP of \$900 is ratably allocated among T's Class V acquisition date assets in propor-

tion to their fair market values as follows:

Asset	Basis
Equipment .....	\$200
Non-actively traded securities .....	100
Building .....	<u>500</u>
Total .....	\$800

(B) The remaining ADSP, \$100, is allocated to goodwill and going concern value (Class VII).

(v) P and T file a consolidated return for 2001 and each following year with P as the common parent of the affiliated group.

(vi) In 2004, a contingent amount of \$120 is paid by P. Assume that, under general principles of tax law, the payment is properly taken into account by P at the time made. In 2004, there is an increase in T's AGUB of \$120. The amount of the increase allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined AGUB	Increase
Equipment .....	\$ 175.00	\$ 200.00	\$ 25.00
Land .....	87.50	100.00	12.50
Building .....	437.50	500.00	62.50
Goodwill and going concern value .....	<u>0.00</u>	<u>20.00</u>	<u>20.00</u>
Total .....	\$ 700.00	\$ 820.00	\$ 120.00

Par. 6. Section 1.338-10 is added to read as follows:

#### §1.338-10 Filing of returns.

(a) *Returns including tax liability from deemed asset sale*—(1) *In general.* Except as provided in paragraphs (a)(2) and

(3) of this section, any deemed sale gain is reported on the final return of old target filed for old target's taxable year that ends at the close of the acquisition date. If old target is the common parent of an affiliated group, the final return may be a consolidated return (any such consolidated re-

turn must also include any deemed sale gain of any members of the consolidated group that are acquired by the purchasing corporation on the same acquisition date as old target).

(2) *Old target's final taxable year otherwise included in consolidated return of*

*selling group*—(i) *General rule.* If the selling group files a consolidated return for the period that includes the acquisition date, old target is disaffiliated from that group immediately before the deemed asset sale and must file a deemed sale return separate from the group that includes only the deemed sale gain and the carryover items specified in paragraph (a)(2)(iii) of this section. The deemed asset sale occurs at the close of the acquisition date and is the last transaction of old target. Any transactions of old target occurring on the acquisition date other than the deemed asset sale are included in the selling group's consolidated return. A deemed sale return includes a combined deemed sale return as defined in paragraph (a)(4) of this section.

(ii) *Separate taxable year.* The deemed asset sale included in the deemed sale return under this paragraph (a)(2) occurs in a separate taxable year, except that old target's taxable year of the sale and the consolidated year of the selling group that includes the acquisition date are treated as the same year for purposes of determining the number of years in a carryover or carryback period.

(iii) *Carryover and carryback of tax attributes.* Target's attributes may be carried over to, and carried back from, the deemed sale return under the rules applicable to a corporation that ceases to be a member of a consolidated group.

(iv) *Old target is a component member of purchasing corporation's controlled group.* For purposes of its deemed sale return, target is a component member of the controlled group of corporations including the purchasing corporation unless target is treated as an excluded member under section 1563(b)(2).

(3) *Old target is an S corporation.* If target is an S corporation for the period that ends on the day before the acquisition date, old target must file a deemed sale return as a C corporation. For this purpose, the principles of paragraph (a)(2) of this section apply. This paragraph (a)(3) does not apply if an election under section 338(h)(10) is made for the S corporation.

(4) *Combined deemed sale return*—(i) *General rule.* Under section 338(h)(15), a combined deemed sale return (combined return) may be filed for all targets from a single selling consolidated group (as defined in §1.338(h)(10)–1(b)(3)) that

are acquired by the purchasing corporation on the same acquisition date and that otherwise would be required to file separate deemed sale returns. The combined return must include all such targets. For example, T and T1 may be included in a combined return if—

(A) T and T1 are directly owned subsidiaries of S;

(B) S is the common parent of a consolidated group; and

(C) P makes qualified stock purchases of T and T1 on the same acquisition date.

(ii) *Gain and loss offsets.* Gains and losses recognized on the deemed asset sales by targets included in a combined return are treated as the gains and losses of a single target. In addition, loss carryovers of a target that were not subject to the separate return limitation year restrictions (SRLY restrictions) of the consolidated return regulations while that target was a member of the selling consolidated group may be applied without limitation to the gains of other targets included in the combined return. If, however, a target has loss carryovers that were subject to the SRLY restrictions while that target was a member of the selling consolidated group, the use of those losses in the combined return continues to be subject to those restrictions, applied in the same manner as if the combined return were a consolidated return. A similar rule applies, when appropriate, to other tax attributes.

(iii) *Procedure for filing a combined return.* A combined return is made by filing a single corporation income tax return in lieu of separate deemed sale returns for all targets required to be included in the combined return. The combined return reflects the deemed asset sales of all targets required to be included in the combined return. If the targets included in the combined return constitute a single affiliated group within the meaning of section 1504(a), the income tax return is signed by an officer of the common parent of that group. Otherwise, the return must be signed by an officer of each target included in the combined return. Rules similar to the rules in §1.1502–75(j) apply for purposes of preparing the combined return. The combined return must include an attachment prominently identified as an ELECTION TO FILE A COMBINED RETURN UNDER SECTION 338(h)–(15). The attachment must—

(A) Contain the name, address, and employer identification number of each target required to be included in the combined return;

(B) Contain the following declaration (or a substantially similar declaration): EACH TARGET IDENTIFIED IN THIS ELECTION TO FILE A COMBINED RETURN CONSENTS TO THE FILING OF A COMBINED RETURN;

(C) For each target, be signed by a person who states under penalties of perjury that he or she is authorized to act on behalf of such target.

(iv) *Consequences of filing a combined return.* Each target included in a combined return is severally liable for any tax associated with the combined return. See §1.338–1(b)(3).

(5) *Deemed sale excluded from purchasing corporation's consolidated return.* Old target may not be considered a member of any affiliated group that includes the purchasing corporation with respect to its deemed asset sale.

(6) *Due date for old target's final return*—(i) *General rule.* Old target's final return is generally due on the 15th day of the third calendar month following the month in which the acquisition date occurs. See section 6072 (time for filing income tax returns).

(ii) *Application of §1.1502–76(c)*—(A) *In general.* Section 1.1502–76(c) applies to old target's final return if old target was a member of a selling group that did not file consolidated returns for the taxable year of the common parent that precedes the year that includes old target's acquisition date. If the selling group has not filed a consolidated return that includes old target's taxable period that ends on the acquisition date, target may, on or before the final return due date (including extensions), either—

(1) File a deemed sale return on the assumption that the selling group will file the consolidated return; or

(2) File a return for so much of old target's taxable period as ends at the close of the acquisition date on the assumption that the consolidated return will not be filed.

(B) *Deemed extension.* For purposes of applying §1.1502–76(c)(2), an extension of time to file old target's final return is considered to be in effect until the last date for making the election under section 338.

(C) *Erroneous filing of deemed sale return.* If, under this paragraph (a)(6)(ii), target files a deemed sale return but the selling group does not file a consolidated return, target must file a substituted return for old target not later than the due date (including extensions) for the return of the common parent with which old target would have been included in the consolidated return. The substituted return is for so much of old target's taxable year as ends at the close of the acquisition date. Under §1.1502-76(c)(2), the deemed sale return is not considered a return for purposes of section 6011 (relating to the general requirement of filing a return) if a substituted return must be filed.

(D) *Erroneous filing of return for regular tax year.* If, under this paragraph (a)(6)(ii), target files a return for so much of old target's regular taxable year as ends at the close of the acquisition date but the selling group files a consolidated return, target must file an amended return for old target not later than the due date (including extensions) for the selling group's consolidated return. (The amended return is a deemed sale return.)

(E) *Last date for payment of tax.* If either a substituted or amended final return of old target is filed under this paragraph (a)(6)(ii), the last date prescribed for payment of tax is the final return due date (as defined in paragraph (a)(6)(i) of this section).

(7) *Examples.* The following examples illustrate this paragraph (a):

*Example 1.* (i) S is the common parent of a consolidated group that includes T. The S group files calendar year consolidated returns. At the close of June 30 of Year 1, P makes a qualified stock purchase of T from S. P makes a section 338 election for T, and T's deemed asset sale occurs as of the close of T's acquisition date (June 30).

(ii) T is considered disaffiliated for purposes of reporting the deemed sale gain. Accordingly, T is included in the S group's consolidated return through T's acquisition date except that the tax liability for the deemed sale gain is reported in a separate deemed sale return of T. Provided that T is not treated as an excluded member under section 1563(b)(2), T is a component member of P's controlled group for the taxable year of the deemed asset sale, and the taxable income bracket amounts available in calculating tax on the deemed sale return must be limited accordingly.

(iii) If P purchased the stock of T at 10 a.m. on June 30 of Year 1, the results would be the same. See paragraph (a)(2)(i) of this section.

*Example 2.* The facts are the same as in *Example 1*, except that the S group does not file consolidated

returns. T must file a separate return for its taxable year ending on June 30 of Year 1, which return includes the deemed asset sale.

(b) *Waiver*—(1) *Certain additions to tax.* An addition to tax or additional amount (addition) under subchapter A of chapter 68 of the Internal Revenue Code arising on or before the last day for making the election under section 338 because of circumstances that would not exist but for an election under section 338, is waived if—

(i) Under the particular statute the addition is excusable upon a showing of reasonable cause; and

(ii) Corrective action is taken on or before the last day.

(2) *Notification.* The Internal Revenue Service should be notified at the time of correction (e.g., by attaching a statement to a return that constitutes corrective action) that the waiver rule of this paragraph (b) is being asserted.

(3) *Elections or other actions required to be specified on a timely filed return*—

(i) *In general.* If paragraph (b)(1) of this section applies or would apply if there were an underpayment, any election or other action that must be specified on a timely filed return for the taxable period covered by the late filed return described in paragraph (b)(1) of this section is considered timely if specified on a late-filed return filed on or before the last day for making the election under section 338.

(ii) *New target in purchasing corporation's consolidated return.* If new target is includible for its first taxable year in a consolidated return filed by the affiliated group of which the purchasing corporation is a member on or before the last day for making the election under section 338, any election or other action that must be specified in a timely filed return for new target's first taxable year (but which is not specified in the consolidated return) is considered timely if specified in an amended return filed on or before such last day, at the place where the consolidated return was filed.

(4) *Examples.* The following examples illustrate this paragraph (b):

*Example 1.* T is an unaffiliated corporation with a tax year ending March 31. At the close of September 20 of Year 1, P makes a qualified stock purchase of T. P does not join in filing a consolidated return. P makes a section 338 election for T on or before June 15 of Year 2, which causes T's taxable year to end as of the close of September 20 of Year 1. An

income tax return for T's taxable period ending on September 20 of Year 1 was due on December 15 of Year 1. Additions to tax for failure to file a return and to pay tax shown on a return will not be imposed if T's return is filed and the tax paid on or before June 15 of Year 2. (This waiver applies even if the acquisition date coincides with the last day of T's former taxable year, i.e., March 31 of Year 2.) Interest on any underpayment of tax for old T's short taxable year ending September 20 of Year 1 runs from December 15 of Year 1. A statement indicating that the waiver rule of this paragraph is being asserted should be attached to T's return.

*Example 2.* Assume the same facts as in *Example 1*. Assume further that new T adopts the calendar year by filing, on or before June 15 of Year 2, its first return (for the period beginning on September 21 of Year 1 and ending on December 31 of Year 1) indicating that a calendar year is chosen. See §1.338-1(b)(1). Any additions to tax or amounts described in this paragraph (b) that arise because of the late filing of a return for the period ending on December 31 of Year 1 are waived, because they are based on circumstances that would not exist but for the section 338 election. Notwithstanding this waiver, however, the return is still considered due March 15 of Year 2, and interest on any underpayment runs from that date.

*Example 3.* Assume the same facts as in *Example 2*, except that T's former taxable year ends on October 31. Although prior to the election old T had a return due on January 15 of Year 2 for its year ending October 31 of Year 1, that return need not be filed because a timely election under section 338 was made. Instead, old T must file a final return for the period ending on September 20 of Year 1, which is due on December 15 of Year 1.

## **§§1.338(b)–1, 1.338(b)–2T, and 1.338(b)–3T [Removed]**

Par. 7. Sections 1.338(b)–1, 1.338(b)–2T, and 1.338(b)–3T, are removed.

Par. 8. Section 1.338(h)(10)–1 is revised to read as follows.

## **§1.338(h)(10)–1 Deemed asset sale and liquidation.**

(a) *Scope.* This section prescribes rules for qualification for a section 338(h)(10) election and for making a section 338(h)(10) election. This section also prescribes the consequences of such election. The rules of this section are in addition to the rules of §§1.338–0 through 1.338–10 and 1.338(i)–1 and, in appropriate cases, apply instead of the rules of §§1.338–0 through 1.338–10 and 1.338(i)–1.

(b) *Definitions*—(1) *Consolidated target.* A consolidated target is a target that is a member of a consolidated group within the meaning of §1.1502-1(h) on the acquisition date and is not the common parent of the group on that date.



(2) *Selling consolidated group.* A *selling consolidated group* is the consolidated group of which the consolidated target is a member on the acquisition date.

(3) *Selling affiliate; affiliated target.* A *selling affiliate* is a domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described in section 1504(a)(2), and does not join in filing a consolidated return with the target. In such case, the target is an *affiliated target*.

(4) *S corporation target.* An *S corporation target* is a target that is an S corporation immediately before the acquisition date.

(5) *S corporation shareholders.* *S corporation shareholders* are the S corporation target's shareholders. Unless otherwise indicated, a reference to S corporation shareholders refers both to S corporation shareholders who do and those who do not sell their target stock.

(6) *Liquidation.* Any reference in this section to a liquidation is treated as a reference to the transfer described in paragraph (d)(4) of this section notwithstanding its ultimate characterization for Federal income tax purposes.

(c) *Section 338(h)(10) election*—(1) *In general.* A section 338(h)(10) election may be made for T if P acquires stock meeting the requirements of section 1504(a)(2) from a selling consolidated group, a selling affiliate, or the S corporation shareholders in a qualified stock purchase.

(2) *Simultaneous joint election requirement.* A section 338(h)(10) election is made jointly by P and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form 8023 in accordance with the instructions to the form. S corporation shareholders who do not sell their stock must also consent to the election. The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(3) *Irrevocability.* A section 338(h)(10) election is irrevocable. If a section 338(h)(10) election is made for T, a section 338 election is deemed made for T.

(4) *Effect of invalid election.* If a section 338(h)(10) election for T is not valid,

the section 338 election for T is also not valid.

(d) *Certain consequences of section 338(h)(10) election.* For purposes of subtitle A of the Internal Revenue Code (except as provided in §1.338-1(b)(2)), the consequences to the parties of making a section 338(h)(10) election for T are as follows:

(1) *P.* P is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock, if any. The effect of a gain recognition election includes a taxable deemed sale by P on the acquisition date of any nonrecently purchased target stock. See §1.338-5(d).

(2) *New T.* The AGUB for new T's assets is determined under §1.338-5 and is allocated among the acquisition date assets under §§1.338-6 and 1.338-7. Notwithstanding paragraph (d)(4) of this section (deemed liquidation of old T), new T remains liable for the tax liabilities of old T (including the tax liability for the deemed sale gain). For example, new T remains liable for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and old T joined in the same consolidated return. See §1.1502-6(a).

(3) *Old T—deemed sale*—(i) *In general.* Old T is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the assumption of or taking subject to liabilities in a single transaction at the close of the acquisition date (but before the deemed liquidation). See §1.338-1(a) regarding the tax characterization of the deemed asset sale. ADSP for old T is determined under §1.338-4 and allocated among the acquisition date assets under §§1.338-6 and 1.338-7. Old T realizes the deemed sale gain from the deemed asset sale before the close of the acquisition date while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders). If T is an affiliated target, or an S corporation target, the principles of §§1.338-2(c)(10) and 1.338-10(a)(1), (5), and (6)(i) apply to the return on which the deemed sale gain is reported. When T is an S corporation target, T's S election continues in effect through the close of the acquisition date

(including the time of the deemed asset sale and the deemed liquidation) notwithstanding section 1362(d)(2)(B). Also, when T is an S corporation target, any direct and indirect subsidiaries of T which T has elected to treat as qualified subchapter S subsidiaries under section 1361(b)(3) remain qualified subchapter S subsidiaries through the close of the acquisition date. No similar rule applies when a qualified subchapter S subsidiary, as opposed to the S corporation that is its owner, is the target the stock of which is actually purchased.

(ii) *Tiered targets.* In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed asset sale of a parent corporation is considered to precede that of its subsidiary. See §1.338-3(4)(i).

(4) *Old T and selling consolidated group, selling affiliate, or S corporation shareholders—deemed liquidation; tax characterization*—(i) *In general.* Old T is treated as if, before the close of the acquisition date, after the deemed asset sale in paragraph (d)(3) of this section, and while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders), it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and ceased to exist. The transfer from old T is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 336 or 337 applies.

(ii) *Tiered targets.* In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed liquidation of a subsidiary corporation is considered to

precede the deemed liquidation of its parent.

(5) *Selling consolidated group, selling affiliate, or S corporation shareholders—*

(i) *In general.* If T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale gain into account under section 1366 and increase or decrease their basis in T stock under section 1367. Members of the selling consolidated group, the selling affiliate, or S corporation shareholders are treated as if, after the deemed asset sale in paragraph (d)(3) of this section and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in paragraph (d)(4)(i) of this section. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 331 or 332 applies.

(ii) *Basis and holding period of T stock not acquired.* A member of the selling consolidated group (or the selling affiliate or an S corporation shareholder) retaining T stock is treated as acquiring the stock so retained on the day after the acquisition date for its fair market value. The holding period for the retained stock starts on the day after the acquisition date. For purposes of this paragraph, the fair market value of all of the T stock equals the grossed-up amount realized on the sale to P of P's recently purchased target stock. See §1.338-4(c).

(iii) *T stock sale.* Members of the selling consolidated group (or the selling affiliate or S corporation shareholders) recognize no gain or loss on the sale or exchange of T stock included in the qualified stock purchase (although they may recognize gain or loss on the T stock in the deemed liquidation).

(6) *Nonselling minority shareholders other than nonselling S corporation shareholders—*(i) *In general.* This paragraph (d)(6) describes the treatment of shareholders of old T other than the following: members of the selling consolidated group, the selling affiliate, S corporation shareholders (whether or not they sell their stock), and P. For a description of the treatment of S corporation shareholders, see paragraph (d)(5) of this section. A shareholder to which this paragraph (d)(6) applies is called a minority shareholder.

(ii) *T stock sale.* A minority shareholder recognizes gain or loss on the shareholder's sale or exchange of T stock included in the qualified stock purchase.

(iii) *T stock not acquired.* A minority shareholder does not recognize gain or loss under this section with respect to shares of T stock retained by the shareholder. The shareholder's basis and holding period for that T stock is not affected by the section 338(h)(10) election.

(7) *Consolidated return of selling consolidated group.* If P acquires T in a qualified stock purchase from a selling consolidated group—

(i) The selling consolidated group must file a consolidated return for the taxable period that includes the acquisition date;

(ii) A consolidated return for the selling consolidated group for that period may not be withdrawn on or after the day that a section 338(h)(10) election is made for T; and

(iii) Permission to discontinue filing consolidated returns cannot be granted for, and cannot apply to, that period or any of the immediately preceding taxable periods during which consolidated returns continuously have been filed.

(8) *Availability of the section 453 installment method.* Solely for purposes of applying sections 453, 453A, and 453B, and the regulations thereunder (the installment method) to determine the consequences to old T in the deemed asset sale and to old T (and its shareholders, if relevant) in the deemed liquidation, the rules in paragraphs (d)(1) through (7) of this section are modified as follows:

(i) *In deemed asset sale.* Old T is treated as receiving in the deemed asset sale new T installment obligations, the terms of which are identical (except as to the obligor) to P installment obligations issued in exchange for recently purchased stock of T. Old T is treated as receiving in cash all other consideration in the deemed asset sale other than the assumption of, or taking subject to, old T liabilities. For example, old T is treated as receiving in cash any amounts attributable to the grossing-up of amount realized under §1.338-4(c). The amount realized for recently purchased stock taken into account in determining ADSP is adjusted (and, thus, ADSP is redetermined) to reflect the amounts paid under an installment obligation for the stock when the total payments

under the installment obligation are greater or less than the amount realized.

(ii) *In deemed liquidation.* Old T is treated as distributing in the deemed liquidation the new T installment obligations that it is treated as receiving in the deemed asset sale. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving in the deemed liquidation the new T installment obligations that correspond to the P installment obligations they actually received individually in exchange for their recently purchased stock. The new T installment obligations may be recharacterized under other rules. See for example §1.453-11(a)(2) which, in certain circumstances, treats the new T installment obligations deemed distributed by old T as if they were issued by new T in exchange for the members' of the selling consolidated group, the selling affiliate's, or the S corporation shareholders' stock in old T. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving all other consideration in the deemed liquidation in cash.

(9) *Treatment consistent with an actual asset sale.* Old T may not assert any provision in section 338(h)(10) or this section to obtain a tax result that would not be obtained if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur.

(e) *Examples.* The following examples illustrate this section:

*Example 1.* (i) S1 owns all of the T stock and T owns all of the stock of T1 and T2. S1 is the common parent of a consolidated group that includes T, T1, and T2. P makes a qualified stock purchase of all of the T stock from S1. S1 joins with P in making a section 338(h)(10) election for T and for the deemed purchase of T1. A section 338 election is not made for T2.

(ii) S1 does not recognize gain or loss on the sale of the T stock and T does not recognize gain or loss on the sale of the T1 stock because section 338(h)(10) elections are made for T and T1. Thus, for example, gain or loss realized on the sale of the T or T1 stock is not taken into account in earnings and profits. However, because a section 338 election is not made for T2, T must recognize any gain or loss realized on the deemed sale of the T2 stock. See §1.338-4(h).

(iii) The results would be the same if S1, T, T1, and T2 are not members of any consolidated group, because S1 and T are selling affiliates.

**Example 2.** (i) S and T are solvent corporations. S owns all of the outstanding stock of T. S and P agree to undertake the following transaction: T will distribute half its assets to S, and S will assume half of T's liabilities. Then, P will purchase the stock of T from S. S and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

(ii) Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph (d)(4) of this section, the transactions described in paragraph (d) of this section are treated in the same manner as if they had actually occurred. Because S and P had agreed that, after T's actual distribution to S of part of its assets, S would sell T to P pursuant to an election under section 338(h)(10), and because paragraph (d)(4) of this section deems T subsequently to have transferred all its assets to its shareholder, T is deemed to have adopted a plan of complete liquidation under section 332. T's actual transfer of assets to S is treated as a distribution pursuant to that plan of complete liquidation.

**Example 3.** (i) S1 owns all of the outstanding stock of both T and S2. All three are corporations. S1 and P agree to undertake the following transaction. T will transfer substantially all of its assets and liabilities to S2, with S2 issuing no stock in exchange therefor, and retaining its other assets and liabilities. Then, P will purchase the stock of T from S1. S1 and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

(ii) Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph (d)(4) of this section, the transactions described in this section are

treated in the same manner as if they had actually occurred. Because old T transferred substantially all of its assets to S2, and is deemed to have distributed all its remaining assets and gone out of existence, the transfer of assets to S2, taking into account the related transfers, deemed and actual, qualifies as a reorganization under section 368(a)(1)(D). Section 361(c)(1) and not section 332 applies to T's deemed liquidation.

**Example 4.** (i) T owns two assets: an actively traded security (Class II) with a fair market value of \$100 and an adjusted basis of \$100, and inventory (Class IV) with a fair market value of \$100 and an adjusted basis of \$100. T has no liabilities. S is negotiating to sell all the stock in T to P for \$100 cash and contingent consideration. Assume that under generally applicable tax accounting rules, P's adjusted basis in the T stock immediately after the purchase would be \$100, because the contingent consideration is not taken into account. Thus, under the rules of §1.338-5, AGUB would be \$100. Under the allocation rules of §1.338-6, the entire \$100 would be allocated to the Class II asset, the actively traded security, and no amount would be allocated to the inventory. P, however, plans immediately to cause T to sell the inventory, but not the actively traded security, so it requests that, prior to the stock sale, S cause T to create a new subsidiary, Newco, and contribute the actively traded security to the capital of Newco. Because the stock in Newco, which would not be actively traded, is a Class V asset, under the rules of §1.338-6 \$100 of AGUB would be allocated to the inventory and no amount of AGUB would be allocated to the Newco stock. Newco's own AGUB, \$0 under the rules of §1.338-5, would be allocated to the actively traded security. When P subsequently causes T to sell the inventory, T would realize no gain or loss instead of realizing gain of \$100.

(ii) Assume that, if the T stock had not itself been sold but T had instead sold both its inventory and the Newco stock to P, T would for tax purposes be deemed instead to have sold both its inventory and actively traded security directly to P, with P deemed then to have created Newco and contributed the actively traded security to the capital of Newco. Section 338, if elected, generally recharacterizes a stock sale as a deemed sale of assets. The tax results of the deemed sale of assets should, where possible, be like those of an actual asset sale. Hence, the deemed sale of assets under section 338(h)(10) should be treated as one of the inventory and actively traded security themselves, not of the inventory and Newco stock. That is the substance of the transaction. The anti-abuse rule of §1.338-1(c) does not apply, because the substance of the deemed sale of assets is a sale of the inventory and the actively traded security themselves, not of the inventory and the Newco stock. Otherwise, the anti-abuse rule might apply.

**Example 5.** (i) T, a member of a selling consolidated group, has only one class of stock, all of which is owned by S1. On March 1 of Year 2, S1 sells its T stock to P for \$80,000, and joins with P in making a section 338(h)(10) election for T. There are no selling costs or acquisition costs. On March 1 of Year 2, T owns land with a \$50,000 basis and \$75,000 fair market value and equipment with a \$30,000 adjusted basis, \$70,000 recomputed basis, and \$60,000 fair market value. T also has a \$40,000 liability. S1 pays old T's allocable share of the selling group's consolidated tax liability for Year 2 including the tax liability for the deemed sale gain (a total of \$13,600).

(ii) ADSP of \$120,000 (\$80,000 + \$40,000 + 0) is allocated to each asset as follows:

Assets	Basis	FMV	Fraction	Allocable ADSP
Land .....	\$ 50,000	\$ 75,000	5/9	\$ 66,667
Equipment .....	<u>30,000</u>	<u>60,000</u>	<u>4/9</u>	<u>53,333</u>
Total .....	\$ 80,000	\$ 135,000	1	\$ 120,000

(iii) Under paragraph (d)(3) of this section, old T has gain on the deemed sale of \$40,000 (consisting of \$16,667 of capital gain and \$23,333 of ordinary income).

(iv) Under paragraph (d)(5)(iii) of this section, S1 recognizes no gain or loss upon its sale of the old T stock to P. S1 also recognizes no gain or loss upon the deemed liquidation of T. See paragraph (d)(4) of this section and section 332.

(v) P's basis in new T stock is P's cost for the stock, \$80,000. See section 1012.

(vi) Under §1.338-5, the AGUB for new T is \$120,000, i.e., P's cost for the old T stock (\$80,000) plus T's liability (\$40,000). This AGUB is allocated as basis among the new T assets under §§1.338-6 and 1.338-7.

**Example 6.** (i) The facts are the same as in *Example 5*, except that S1 sells 80 percent of the old T stock to P for \$64,000, rather than 100 percent of the old T stock for \$80,000.

(ii) The consequences to P, T, and S1 are the same as in *Example 5*, except that:

(A) P's basis for its 80-percent interest in the new T stock is P's \$64,000 cost for the stock. See section 1012.

(B) Under §1.338-5, the AGUB for new T is \$120,000 (i.e., \$64,000/.8 + \$40,000 + \$0).

(C) Under paragraph (d)(4) of this section, S1 recognizes no gain or loss with respect to the retained stock in T. See section 332.

(D) Under paragraph (d)(5)(ii) of this section, the basis of the T stock retained by S1 is \$16,000 (i.e., \$120,000 - \$40,000 (the ADSP amount for the old T assets over the sum of new T's liabilities immediately after the acquisition date) × .20 (the proportion of T stock retained by S1)).

**Example 7.** (i) The facts are the same as in *Example 6*, except that K, a shareholder unrelated to T or P, owns the 20 percent of the T stock that is not acquired by P in the qualified stock purchase. K's basis in its T stock is \$5,000.

(ii) The consequences to P, T, and S1 are the same as in *Example 6*.

(iii) Under paragraph (d)(6)(iii) of this section, K recognizes no gain or loss, and K's basis in its T stock remains at \$5,000.

**Example 8.** (i) The facts are the same as in *Example 5*, except that the equipment is held by T1, a wholly-owned subsidiary of T, and a section 338(h)(10) election is also made for T1. The T1 stock

has a fair market value of \$60,000. T1 has no assets other than the equipment and no liabilities. S1 pays old T's and old T1's allocable shares of the selling group's consolidated tax liability for Year 2 including the tax liability for T and T1's deemed sale gain.

(ii) ADSP for T is \$120,000, allocated \$66,667 to the land and \$53,333 to the stock. Old T's deemed sale gain is \$16,667 (the capital gain on its deemed sale of the land). Under paragraph (d)(5)(iii) of this section, old T does not recognize gain or loss on its deemed sale of the T1 stock. See section 332.

(iii) ADSP for T1 is \$53,333 (i.e., \$53,333 + \$0 + \$0). On the deemed sale of the equipment, T1 recognizes ordinary income of \$23,333.

(iv) Under paragraph (d)(5)(iii) of this section, S1 does not recognize gain or loss upon its sale of the old T stock to P.

**Example 9.** (i) The facts are the same as in *Example 8*, except that P already owns 20 percent of the T stock, which is nonrecently purchased stock with a basis of \$6,000, and that P purchases the remaining 80 percent of the T stock from S1 for \$64,000.

(ii) The results are the same as in *Example 8*, except that under paragraph (d)(1) of this section and



§1.338-5(d), P is deemed to have made a gain recognition election for its nonrecently purchased T stock. As a result, P recognizes gain of \$10,000 and its basis in the nonrecently purchased T stock is increased from \$6,000 to \$16,000. P's basis in all the T stock is \$80,000 (i.e., \$64,000 + \$16,000). The computations are as follows:

(A) P's grossed-up basis for the recently purchased T stock is \$64,000 (i.e., \$64,000 (the basis of the recently purchased T stock)  $\times$  (1 - .2)/(.8) (the fraction in section 338(b)(4))).

(B) P's basis amount for the nonrecently purchased T stock is \$16,000 (i.e., \$64,000 (the grossed-up basis in the recently purchased T stock)  $\times$  (.2)/(1.0 - .2) (the fraction in section 338(b)(3)(B))).

(C) The gain recognized on the nonrecently purchased stock is \$10,000 (i.e., \$16,000 - \$6,000).

*Example 10.* (i) T is an S corporation whose sole class of stock is owned 40 percent each by A and B and 20 percent by C. A and B each has an adjusted basis of \$10,000 in the stock. C has an adjusted basis of \$5,000 in the stock. A, B, and C hold no installment obligations to which section 453A applies. On March 1 of Year 1, A sells its stock to P for \$40,000 in cash and B sells its stock to P for a \$25,000 note issued by P and real estate having a fair market value of \$15,000. The \$25,000 note, due in full in Year 7, is not publicly traded and bears adequate stated interest. A and B have no selling expenses. T's sole asset is real estate, which has a value of \$110,000 and an adjusted basis of \$35,000. Also, T's real estate is encumbered by long-outstanding purchase-money indebtedness of \$10,000. The real estate does not have built-in gain subject to section 1374. A, B, and C join with P in making a section 338(h)(10) election for T.

(ii) Solely for purposes of application of sections 453, 453A, and 453B, old T is considered in its deemed asset sale to receive back from new T the \$25,000 note (considered issued by new T) and \$75,000 of cash (total consideration of \$80,000 paid for all the stock sold, which is then divided by .80 in the grossing-up, with the resulting figure of \$100,000 then reduced by the amount of the installment note). Absent an election under section 453(d), gain is reported by old T under the installment method.

(iii) In applying the installment method to old T's deemed asset sale, the contract price for old T's assets deemed sold is \$100,000, the \$110,000 selling price reduced by the indebtedness of \$10,000 to which the assets are subject. (The \$110,000 selling price is itself the sum of the \$80,000 grossed-up in paragraph (ii) above to \$100,000 and the \$10,000 liability.) Gross profit is \$75,000 (\$110,000 selling price - old T's basis of \$35,000). Old T's gross profit ratio is 0.75 (gross profit of \$75,000  $\div$  \$100,000 contract price). Thus, \$56,250 (0.75  $\times$  the \$75,000 cash old T is deemed to receive in Year 1) is Year 1 gain attributable to the sale, and \$18,750 (\$75,000 - \$56,250) is recovery of basis.

(iv) In its liquidation, old T is deemed to distribute the \$25,000 note to B, since B actually sold the stock partly for that consideration. To the extent of the remaining liquidating distribution to B, it is deemed to receive, along with A and C, the balance of old T's liquidating assets in the form of cash. Under section 453(h), B, unless it makes an election under section 453(d), is not required to treat the re-

ceipt of the note as a payment for the T stock; P's payment of the \$25,000 note in Year 7 to B is a payment for the T stock. Because section 453(h) applies to B, old T's deemed liquidating distribution of the note is, under section 453B(h), not treated as a taxable disposition by old T.

(v) Under section 1366, A reports 40 percent, or \$22,500, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases A's \$10,000 adjusted basis in the T stock to \$32,500. Next, in old T's deemed liquidation, A is considered to receive \$40,000 for its old T shares, causing it to recognize an additional \$7,500 gain in Year 1.

(vi) Under section 1366, B reports 40 percent, or \$22,500, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases B's \$10,000 adjusted basis in its T stock to \$32,500. Next, in old T's deemed liquidation, B is considered to receive the \$25,000 note and \$15,000 of other consideration. Applying section 453, including section 453(h), to the deemed liquidation, B's selling price and contract price are both \$40,000. Gross profit is \$7,500 (\$40,000 selling price - B's basis of \$32,500). B's gross profit ratio is 0.1875 (gross profit of \$7,500  $\div$  \$40,000 contract price). Thus, \$2,812.50 (0.1875  $\times$  \$15,000) is Year 1 gain attributable to the deemed liquidation. In Year 7, when the \$25,000 note is paid, B has \$4,687.50 (0.1875  $\times$  \$25,000) of additional gain.

(vii) Under section 1366, C reports 20 percent, or \$11,250, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases C's \$5,000 adjusted basis in its T stock to \$16,250. Next, in old T's deemed liquidation, C is considered to receive \$20,000 for its old T shares, causing it to recognize an additional \$3,750 gain in Year 1. Finally, under paragraph (d)(5)(ii) of this section, C is considered to acquire its stock in T on the day after the acquisition date for \$20,000 (fair market value = grossed-up amount realized of \$100,000  $\times$  20%). C's holding period in the stock deemed received in new T begins at that time.

(f) *Inapplicability of provisions.* The provisions of section 6043, §1.331-1(d), and §1.332-6 (relating to information returns and recordkeeping requirements for corporate liquidations) do not apply to the deemed liquidation of old T under paragraph (d)(4) of this section.

(g) *Required information.* The Commissioner may exercise the authority granted in section 338(h)(10)(C)(iii) to require provision of any information deemed necessary to carry out the provisions of section 338(h)(10) by requiring submission of information on any tax reporting form.

Par. 9. Section 1.338(i)-1 is revised to read as follows:

#### *§1.338(i)-1 Effective dates.*

The provisions of §§1.338-0 through 1.338-10 and 1.338(h)(10)-1 apply to any qualified stock purchase occurring

after the date that final regulations are published in the **Federal Register**. For rules applicable to qualified stock purchases before the date that final regulations are published in the **Federal Register**, see §§1.338-0 through 1.338-5, 1.338(b)-1, 1.338(b)-2T, 1.338(b)-3T, 1.338(h)(10)-1, and 1.338(i)-1 as contained in 26 CFR part 1 revised April 1, 1999.

Par. 10. Section 1.1060-1 is added to read as follows:

#### *§1.1060-1 Special allocation rules for certain asset acquisitions.*

(a) *Scope*—(1) *In general.* This section prescribes rules relating to the requirements of section 1060, which, in the case of an applicable asset acquisition, requires the transferor (the seller) and the transferee (the purchaser) each to allocate the consideration paid or received in the transaction among the assets transferred in the same manner as amounts are allocated under section 338(b)(5) (relating to the allocation of adjusted grossed-up basis among the assets of the target corporation when a section 338 election is made). In the case of an applicable asset acquisition described in paragraph (b)(1) of this section, sellers and purchasers must allocate the consideration under the residual method as described in §§1.338-6 and 1.338-7 in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets. For rules relating to distributions of partnership property or transfers of partnership interests which are subject to section 1060(d), see §1.755-2T.

(2) *Effective date.* The provisions of this section apply to any asset acquisition occurring after the date that final regulations are published in the **Federal Register**.

(3) *Outline of topics.* In order to facilitate the use of this section, this paragraph (a)(3) lists the major paragraphs in this section as follows:

- (a) *Scope.*
  - (1) *In general.*
  - (2) *Effective date.*
  - (3) *Outline of topics.*
- (b) *Applicable asset acquisition.*
  - (1) *In general.*
  - (2) *Assets constituting a trade or business.*
- (i) *In general.*

- (ii) Goodwill or going concern value.
- (iii) Factors indicating goodwill or going concern value.
- (3) Examples.
- (4) Asymmetrical transfers of assets.
- (5) Related transactions.
- (6) More than a single trade or business.
- (7) Covenant entered into by the seller.
- (8) Partial non-recognition exchanges.
- (c) Allocation of consideration among assets under the residual method.
  - (1) Consideration.
  - (2) Allocation of consideration among assets.
  - (3) Certain costs.
  - (4) Effect of agreement between parties.
  - (d) Examples.
  - (e) Reporting requirements.
    - (1) Applicable asset acquisitions.
      - (i) In general.
      - (ii) Time and manner of reporting.
        - (A) In general.
        - (B) Additional reporting requirement.
    - (2) Transfers of interests in partnerships.
      - (b) *Applicable asset acquisition*—(1) *In general.* An applicable asset acquisition is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and, except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.
      - (2) *Assets constituting a trade or business*—(i) *In general.* For purposes of this section, a group of assets constitutes a trade or business if—
        - (A) The use of such assets would constitute an active trade or business under section 355; or
        - (B) Its character is such that goodwill or going concern value could under any circumstances attach to such group.
      - (ii) *Goodwill or going concern value.* Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to con-

tinue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

(iii) *Factors indicating goodwill or going concern value.* In making the determination in paragraph (b)(2) of this section, all the facts and circumstances surrounding the transaction are taken into account. Whether sufficient consideration is available to allocate to goodwill or going concern value after the residual method is applied is not relevant in determining whether goodwill or going concern value could attach to a group of assets. Factors to be considered include—

(A) The presence of any intangible assets (whether or not those assets are section 197 intangibles), provided, however, that the transfer of such an asset in the absence of other assets will not be a trade or business for purposes of section 1060;

(B) The existence of an excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going concern value) as shown in the financial accounting books and records of the purchaser; and

(C) Related transactions, including lease agreements, licenses, or other similar agreements between the purchaser and seller (or managers, directors, owners, or employees of the seller) in connection with the transfer.

(3) *Examples.* The following examples illustrate paragraphs (b)(1) and (2) of this section:

*Example 1.* S is a high grade machine shop that manufactures microwave connectors in limited quantities. It is a successful company with a reputation within the industry and among its customers for manufacturing unique, high quality products. Its tangible assets consist primarily of ordinary machinery for working metal and plating. It has no secret formulas or patented drawings of value. P is a company that designs, manufactures, and markets electronic components. It wants to establish an immediate presence in the microwave industry, an area in which it previously has not been engaged. P is acquiring assets of a number of smaller companies and hopes that these assets will collectively allow it to offer a broad product mix. P acquires the assets of S in order to augment its product mix and to promote

its presence in the microwave industry. P will not use the assets acquired from S to manufacture microwave connectors. The assets transferred are assets that constitute a trade or business in the hands of the seller. Thus, P's purchase of S's assets is an applicable asset acquisition. The fact that P will not use the assets acquired from S to continue the business of S does not affect this conclusion.

*Example 2.* S, a sole proprietor who operates a car wash, both leases the building housing the car wash and sells all of the car wash equipment to P. S's use of the building and the car wash equipment constitute a trade or business. P begins operating a car wash in the building it leases from S. Because the assets transferred together with the asset leased are assets which constitute a trade or business, P's purchase of S's assets is an applicable asset acquisition.

*Example 3.* S, a corporation, owns a retail store business in State X and conducts activities in connection with that business enterprise that meet the active trade or business requirement of section 355. P is a minority shareholder of S. S distributes to P all the assets of S used in S's retail business in State X in complete redemption of P's stock in S held by P. The distribution of S's assets in redemption of P's stock is treated as a sale or exchange under sections 302(a) and 302(b)(3), and P's basis in the assets distributed to it is determined wholly by reference to the consideration paid, the S stock. Thus, S's distribution of assets constituting a trade or business to P is an applicable asset acquisition.

*Example 4.* S is a manufacturing company with an internal financial bookkeeping department. P is in the business of providing a financial bookkeeping service on a contract basis. As part of an agreement for P to begin providing financial bookkeeping services to S, P agrees to buy all of the assets associated with S's internal bookkeeping operations and provide employment to any of S's bookkeeping department employees who choose to accept a position with P. In addition to selling P the assets associated with its bookkeeping operation, S will enter into a long term contract with P for bookkeeping services. Because assets transferred from S to P, along with the related contract for bookkeeping services, are a trade or business in the hands of P, the sale of the bookkeeping assets from S to P is an applicable asset acquisition.

(4) *Asymmetrical transfers of assets.* If, under general principles of tax law, a seller is not treated as transferring the same assets as the purchaser is treated as acquiring, the assets acquired by the purchaser constitute a trade or business, and, except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration, then the purchaser is subject to section 1060.

(5) *Related transactions.* Whether the assets transferred constitute a trade or business is determined by aggregating all transfers from the seller to the purchaser in a series of related transactions. Except

as provided in paragraph (b)(8) of this section, all assets transferred from the seller to the purchaser in a series of related transactions are included in the group of assets among which the consideration paid or received in such series is allocated under the residual method. The principles of §1.338-1(c) are also applied in determining which assets are included in the group of assets among which the consideration paid or received is allocated under the residual method.

(6) *More than a single trade or business.* If the assets transferred from a seller to a purchaser include more than one trade or business, then, in applying this section, all of the assets transferred (whether or not transferred in one transaction or a series of related transactions and whether or not part of a trade or business) are treated as a single trade or business.

(7) *Covenant entered into by the seller.* If, in connection with an applicable asset acquisition, the seller enters into a covenant (e.g., a covenant not to compete) with the purchaser, that covenant is treated as an asset transferred as part of a trade or business.

(8) *Partial non-recognition exchanges.* A transfer may constitute an applicable asset acquisition notwithstanding the fact that no gain or loss is recognized with respect to a portion of the group of assets transferred. All of the assets transferred, including the non-recognition assets, are taken into account in determining whether the group of assets constitutes a trade or business. The allocation of consideration under paragraph (c) of this section is done without taking into account either the non-recognition assets or the amount of money or other property that is treated as transferred in exchange for the non-recognition assets (together, the non-recognition exchange property). The basis in and gain or loss recognized with respect to the non-recognition exchange property are determined under such rules as would otherwise apply to an exchange of such property. The amount of the money and other property treated as exchanged for non-recognition assets is the amount by which the fair market value of the non-recognition assets transferred by one party exceeds the fair market value of the

non-recognition assets transferred by the other (to the extent of the money and the fair market value of property transferred in the exchange). The money and other property that are treated as transferred in exchange for the non-recognition assets (and which are not included among the assets to which section 1060 applies) are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, then from Class IV assets, then from Class V assets, then from Class VI assets, and then from Class VII assets. For this purpose, liabilities assumed (or to which a non-recognition exchange property is subject) are treated as Class I assets. See *Example 1* in paragraph (d) of this section for an example of the application of section 1060 to a single transaction which is, in part, a non-recognition exchange.

(c) *Allocation of consideration among assets under the residual method* —(1) *Consideration.* The seller's consideration is the amount, in the aggregate, realized from selling the assets in the applicable asset acquisition under section 1001(b). The purchaser's consideration is the amount, in the aggregate, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis.

(2) *Allocation of consideration among assets.* For purposes of determining the seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all the assets sold by using the residual method under §§1.338-6 and 1.338-7, substituting consideration for ADSP. For purposes of determining the purchaser's basis in each of the assets purchased in an applicable asset acquisition, the purchaser allocates consideration to all the assets purchased by using the residual method under §§1.338-6 and 1.338-7, substituting consideration for AGUB. In allocating consideration, the rules set forth in paragraphs (c)(3) and (4) of this section apply in addition to the rules in §§1.338-6 and 1.338-7.

(3) *Certain costs.* The seller and purchaser each adjusts the amount allocated to an individual asset to take into account

the specific identifiable costs incurred in transferring that asset in connection with the applicable asset acquisition (e.g., real estate transfer costs or security interest perfection costs). Costs so allocated increase, or decrease, as appropriate, the total consideration that is allocated under the residual method. No adjustment is made to the amount allocated to an individual asset for general costs associated with the applicable asset acquisition as a whole or with groups of assets included therein (e.g., non-specific appraisal fees or accounting fees). These latter amounts are taken into account only indirectly through their effect on the total consideration to be allocated.

(4) *Effect of agreement between parties.* If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4). Nothing in this paragraph (c)(4) restricts the Commissioner's authority to challenge the allocations or values arrived at in an allocation agreement. This paragraph (c)(4) does not apply if the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).

(d) *Examples.* The following examples illustrate this section:

*Example 1.* (i) On January 1, 2001, A transfers assets X, Y, and Z to B in exchange for assets D, E, and F plus \$1,000 cash.

(ii) Assume the exchange of assets constitutes an exchange of like-kind property to which section 1031 applies. Assume also that goodwill or going concern value could under any circumstances attach to each of the DEF and XYZ groups of assets and, therefore, each group constitutes a trade or business under section 1060.

(iii) Assume the fair market values of the assets and the amount of money transferred are as follows:



By A		By B	
Asset	Fair Market Value	Asset	Fair Market Value
X .....	\$ 400	D .....	\$ 40
Y .....	400	E .....	30
Z .....	200	F .....	30
		Cash (amount) .....	1,000
Total .....	\$ 1,000	Total .....	\$ 1,100

(iv) Under paragraph (b)(8) of this section, for purposes of allocating consideration under paragraph (c) of this section, the like-kind assets exchanged and any money or other property that are treated as transferred in exchange for the like-kind property are excluded from the application of section 1060.

(v) Since assets X, Y, and Z are like-kind property, they are excluded from the application of the section 1060 allocation rules.

(vi) Since assets D, E, and F are like-kind property, they are excluded from the application of the section 1060 allocation rules. In addition, \$900 of the \$1,000 cash B gave to A for A's like-kind assets is treated as transferred in exchange for the like-kind property in order to equalize the fair market values of the like-kind assets. Therefore, \$900 of the cash is excluded from the application of the section 1060 allocation rules.

(vii) \$100 of the cash is allocated under section 1060 and paragraph (c) of this section.

(viii) A, as transferor of assets X, Y, and Z, received \$100 that must be allocated under section 1060 and paragraph (c) of this section. Since A transferred no Class I, II, III, IV, V, or VI assets to which section 1060 applies, in determining its amount realized for the part of the exchange to which section 1031 does not apply, the \$100 is allocated to Class VII assets (goodwill and going concern value).

(ix) A, as transferee of assets D, E, and F, gave consideration only for assets to which section 1031 applies. Therefore, the allocation rules of section 1060 and paragraph (c) of this section are not applied to determine the bases of the assets A received.

(x) B, as transferor of assets D, E, and F, received consideration only for assets to which section 1031 applies. Therefore, the allocation rules of section 1060 do not apply in determining B's gain or loss.

(xi) B, as transferee of assets X, Y, and Z, gave A \$100 that must be allocated under section 1060 and paragraph (c) of this section. Since B received from A no Class I, II, III, IV, V, or VI assets to which section 1060 applies, the \$100 consideration is allocated by B to Class VII assets (goodwill and going concern value).

**Example 2.** (i) On January 1, 2001, S, a sole proprietor, sells to P, a corporation, a group of assets that constitutes a trade or business under paragraph (b)(2) of this section. S, who plans to retire immediately, also executes in P's favor a covenant not to compete. P pays S \$3,000 in cash and assumes \$1,000 in liabilities. Thus, the total consideration is \$4,000.

(ii) On the purchase date, P and S also execute a separate agreement that states that the fair market values of the Class II, Class III, Class V, and Class VI assets S sold to P are as follows:

Asset Class	Asset	Fair Market Value
II	Actively traded securities .....	\$ 500
	Total Class II .....	500
III	Accounts receivable .....	200
	Total Class III .....	200
V	Furniture and fixtures .....	800
	Building .....	800
	Land .....	200
	Equipment .....	400
	Total Class V .....	2,200
VI	Covenant not to compete .....	900
	Total Class VI .....	900

(iii) P and S each allocate the consideration in the transaction among the assets transferred under paragraph (c) of this section in accordance with the agreed upon fair market values of the assets, so that \$500 is allocated to Class II assets, \$200 is allocated to the Class III asset, \$2,200 is allocated to Class V assets, \$900 is allocated to Class VI assets, and \$200 (\$4,000 total consideration less \$3,800 allocated to assets in Classes II, III, V, and VI) is allocated to the Class VII assets (goodwill and going concern value).

(iv) In connection with the examination of P's return, the District Director, in determining the fair market values of the assets transferred, may disregard the parties' agreement. Assume that the District Director correctly determines that the fair market value of the covenant not to compete was \$500. Since the allocation of consideration among Class II, III, V, and VI assets results in allocation up to the fair market value limitation, the \$600 of unallocated consideration resulting from the District Director's redetermination of the value of the covenant not to compete is allocated to Class VII assets (goodwill and going concern value).

**(e) Reporting requirements—(1) Applicable asset acquisitions—(i) In general.** Unless otherwise excluded from this requirement by the Commissioner, the seller and the purchaser in an applicable asset acquisition each must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. They also must report information concerning subsequent adjustments to consideration.

**(ii) Time and manner of reporting—(A) In general.** The seller and the purchaser each must file asset acquisition statements

on Form 8594 with their income tax returns or returns of income for the taxable year that includes the first date assets are sold pursuant to an applicable asset acquisition. This reporting requirement applies to all asset acquisitions described in this section. For reporting requirements relating to asset acquisitions occurring before the date final regulations are published in the Federal Register, as described in paragraph (a)(2) of this section, see the temporary regulations under section 1060 in effect prior to the date final regulations are published in the Federal Register (§1.1060-1T as contained in 26 CFR part 1 revised April 1, 1999).

**(B) Additional reporting requirement.** When an increase or decrease in consideration is taken into account after the close of first taxable year that includes the first date assets are sold in an applicable asset acquisition, the seller and the purchaser each must file a supplemental asset acquisition statement on Form 8594 with the income tax return or return of income for the taxable year in which the increase (or decrease) is properly taken into account.

**(2) Transfers of interests in partnerships.** For reporting requirements relating to the transfer of the partnership interest, see §1.755-2T(c).

## §1.1060-1T [Removed]

Par. 11. Section 1.1060-1T is removed.

## PART 602-OMB CONTROL NUMBERS UNDER PAPERWORK REDUCTION ACT

Par. 12. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

## §602.101 [Amended]

Par. 13. In §602.101, paragraph (b) is amended by removing the entries for 1.338(b)-1 and 1.1060-1T from the table.

(Filed by the Office of the Federal Register on August 4, 1999, 9:14 a.m., and published in the issue of the Federal Register for August 10, 1999, 64 F.R. 43461)

## Guidance Relating to Article XXI of the United States-Canada Income Tax Convention

### Notice 99-47

#### PURPOSE

This notice provides guidance concerning a competent authority agreement between the United States and Canada that implements Article XXI (Exempt Organizations) of the United States-Canada Income Tax Convention (Treaty).

#### BACKGROUND

Article XXI of the Treaty generally provides for deduction of cross-border charitable contributions, and reciprocal recognition of exemption for religious, scientific, literary, educational, or charitable organizations. Diplomatic notes that accompany the Treaty provide that the competent authorities of each of the Contracting States shall review the procedures and requirements for an organization of the other Contracting State to establish its status as a religious, scientific, literary, educational, or charitable organization entitled to exemption under paragraph 1 of Article XXI, or as an eligible recipient of the charitable contributions referred to in paragraphs 5 and 6 of Article XXI, with a view to avoiding duplicate application by such organizations to the administering agencies of both Contracting States. The diplomatic notes also provide that if a Contracting State determines that the other Contracting State maintains procedures to determine such status and rules for qualification that are compatible with such procedures and rules of the first-mentioned Contracting State, it is contemplated that such first-mentioned Contracting State shall accept the certification of the other administering agency of the other Contracting State as to such status for the purpose of making the necessary

determinations under paragraphs 1, 5 and 6 of Article XXI.

#### SCOPE OF TREATY RELIEF

The U.S. and Canadian Competent Authorities, pursuant to Article XXVI (Mutual Agreement Procedure) of the Treaty, have entered into a mutual agreement that implements Article XXI as contemplated by the diplomatic notes. Under the terms of the agreement, recognized religious, scientific, literary, educational, or charitable organizations that are organized under the laws of either the U.S. or Canada will automatically receive recognition of exemption without application in the other country. U.S. organizations must be recognized as exempt under section 501(c)(3) of the Code in order to qualify for this treatment. Similarly, Revenue Canada must recognize Canadian organizations as Canadian registered charities.

Moreover, recognized charitable organizations resident in one country will be eligible to receive deductible charitable contributions from residents of the other country. However, in the case of a contribution (or contributions) by a resident or citizen of the United States (other than a contribution to a college or university at which the citizen or resident or a member of his family is or was enrolled), U.S. law requires that the amount of deductions in the aggregate for a taxable year may not exceed a certain percentage of the donor's Canadian source income. Any excess contribution that is not deductible as a result of this limitation may be carried over and deducted in subsequent taxable years, subject to the same limitations.

Furthermore, the U.S. will presume, in the absence of receiving certain financial information, that all Canadian registered charities are private foundations. Accordingly, if a Canadian registered charity does not provide the U.S. with the financial information needed to determine its foundation classification, the organization will be presumed to be a private foundation under U.S. law, the donor's deductible contributions will be limited to 30 percent of the donor's Canadian source income, and the organization will not have the benefit of being listed in Publication 78, Cumulative List of Organizations. Moreover, although the Canadian registered charity will not be required to

apply for exemption, a donor claiming a charitable contribution deduction will be required to show that the organization is a Canadian registered charity.

Alternatively, if a Canadian registered charity provides the U.S. with the information needed to determine its foundation classification, aside from automatic recognition of exemption, the organization will be listed in Publication 78, as a foreign organization, and will be eligible to receive contributions deductible up to 50 percent of the donor's Canadian source income, assuming it is determined not to be a private foundation. If the Canadian registered charity submits information that establishes that it is a private foundation, it will nevertheless be listed in Publication 78, but deductible contributions will be limited to 30 percent of the donor's Canadian source income.

Under the agreement, recognition of exemption by the U.S. of a Canadian registered charity will remain in effect until the U.S. determines that the organization fails to satisfy the requirements for exempt status under U.S. law. Further, Canadian organizations will be required to file the applicable Form 990, Return of Organizations Exempt From Income Tax, or Form 990-PF, Return of Private Foundation, unless they receive less than \$25,000 of U.S. source income.

#### DISCLOSURE REQUIREMENT

Section 6114(a) of the Code requires that taxpayers taking the position that a U.S. treaty overrules a general U.S. tax principle or law must disclose such position on a return of tax or, if no return of tax is required to be filed, as the Internal Revenue Service may prescribe. Accordingly, taxpayers claiming exemption or charitable contribution deductions pursuant to this agreement must disclose this position on their income tax return for the year in which the charitable contribution deduction or claim for exemption is made. Taxpayers may use Form 8833 for this purpose, or they may attach to their return a separate statement indicating that they are claiming exemption or a charitable contribution deduction pursuant to Article XXI of the Treaty. Taxpayers may make reference to Notice 99-47 in their disclosure statement.

## DRAFTING INFORMATION

The principal author of this notice is Patrick Kevin Orzel of the Office of Assistant Commissioner (International). For further information regarding this notice, contact Mr. Orzel at (202) 874-1550 (not a toll-free number).

## Notice of Proposed Rulemaking and Notice of Public Hearing

### Guidance under section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition.

#### REG-116733-98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. Changes to the applicable law were made by the Taxpayer Relief Act of 1997. These proposed regulations affect corporations and are necessary to provide them with guidance needed to comply with these changes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by January 5, 2000. Outlines of topics to be discussed at the public hearing scheduled for January 26, 2000, at 10 a.m. must be received by January 5, 2000.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG-116733-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-116733-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers

may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.ustreas.gov/tax\\_regs/regsglist.html](http://www.irs.ustreas.gov/tax_regs/regsglist.html). The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Brendan O'Hara, (202) 622-7530; concerning submissions of comments, delivering comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7190 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### *Background*

##### *A. State of the Law Before Section 355(e)*

Section 355 generally provides that, if a corporation distributes to its shareholders stock of a corporation which it controls immediately before the distribution and certain other conditions are met, neither the distributing corporation nor its shareholders recognize gain or loss. A number of the conditions for tax free treatment (for example, the continuity of interest requirement of §1.355-2(c), the "no device" requirement of section 355(a)(1)(B), the five-year active business requirement of section 355(b), and the limitation on disqualified stock under section 355(d)) operate to limit the circumstances in which the distributing or controlled corporation can undergo changes of control in conjunction with a distribution that qualifies for corporate and shareholder-level nonrecognition under section 355. Nevertheless, prior to the enactment of section 355(e), it was possible for such changes to occur, for example, in the context of tax free reorganizations, while qualifying for tax free treatment under section 355. See, e.g., *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

##### *B. Legislative Proposals Leading to Section 355(e)*

As part of its Fiscal Year 1997 Budget, the Administration proposed a provision

that would require a distributing corporation to recognize gain on the distribution of a controlled corporation's stock unless the direct and indirect shareholders of the distributing corporation, as a group, controlled at least 50 percent of the vote and value of both corporations at all times during the 4-year period beginning 2 years before the distribution. See Department of the Treasury, *General Explanation of the Administration's Revenue Proposals*, p. 86 (March 1996) (hereinafter referred to as the "Administration Proposal"). Under the Administration Proposal, the retained 50-percent interest must consist of "permissible stock," which includes, in addition to stock retained over the 4-year period, stock of the distributing or controlled corporation "received by the shareholder in a transaction which is unrelated to the distribution . . ." Revenue Proposals Contained in President Clinton's Budget Plan as Released on Mar. 19, 1996, §9522, [1996] 83 Stand. Fed. Tax Rep. (CCH) No. 15A.

The Administration Proposal described an unrelated transaction as, "[a] transaction that is not pursuant to a common plan or arrangement that includes the distribution," and cited a hostile acquisition of the distributing or controlled corporation commencing after the distribution as an example of an unrelated transaction. The Administration Proposal contrasted this with a friendly acquisition, which generally would be considered related to the distribution if the acquisition was pursuant to an arrangement negotiated prior to the distribution, even if the acquisition was subject to various conditions at the time of the distribution.

On April 17, 1997, House Ways and Means Committee Chairman Archer and Senate Finance Committee Chairman Roth and Ranking Member Moynihan introduced identical bills (H.R. 1365, 105th Cong. (1997) and S. 612, 105th Cong. (1997), hereinafter referred to as the "Bills") that provided for a new section 355(e) that is similar to the enacted version. The Bills were concerned with a "plan (or series of related transactions) pursuant to which a person acquires stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation . . ." S. 612, 105th Cong. (1997). The introductory statement to the legislation contained a



reference to acquisitions “pursuant to a plan or arrangement in existence on the date of distribution . . . .” The statement further explained: “Whether a corporation is acquired would be determined under rules similar to those of present-law section 355(d), except that acquisitions would not be restricted to purchase transactions. Thus an acquisition would occur if a person-or persons acting in concert- . . . acquired . . . stock . . . pursuant to a plan or arrangement.” See 143 Cong. Rec. E703 (Apr. 17, 1997) (introductory statement of Chairman Archer); 143 Cong. Rec. S3360 (Apr. 17, 1997) (introductory statement of Chairman Roth).

### C. Enactment of Section 355(e)

Section 355(e) was enacted in 1997. Public Law 105-34, section 1012(a) (1997). The committee reports state that section 355 was intended to permit the tax free division of existing business arrangements among existing shareholders. The reports state that “[i]n cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired” and provide that gain is recognized “if, pursuant to a plan or arrangement in existence on the date of distribution, either the controlled or distributing corporation is acquired . . . .” H.R. Rep. No. 105-148, at 462 (1997); *see also* S. Rep. No. 105-33, at 139-40 (1997) (slight variation in language). The Conference Report adds, “[a]s under the House bill and Senate amendment, a public offering of sufficient size can result in an acquisition that causes gain recognition under the provision.” H.R. Conf. Rep. No. 105-220, at 533 (1997).

The statute as enacted contained two important changes from the Administration Proposal and Bills relevant to determining whether an acquisition is part of a plan (or series of related transactions) that includes the distribution. In the Bills, proposed sections 355(e)(2)(A)(ii) and (4)(C)(i) provided that a “person,” as modified by section 355(d)(7), must acquire 50 percent or more of the distributing or controlled corporation. The term “plan or arrangement” used in section 355(d)(7)(B) treats two or more persons acting “pursuant to a plan or arrangement”

with regard to a stock acquisition as one person. However, when section 355(e) was enacted, the reference in section 355(e)(2)(A)(ii) to acquisitions by a “person” was changed to “1 or more persons.” In addition, the reference to section 355(d)(7)(B) (treating two or more persons acting “pursuant to a plan or arrangement” as one person) was deleted from section 355(e)(4)(C)(i). The effect of these two changes is to remove the requirement that 50 percent or more of the stock of the distributing or controlled corporation must be acquired by acquirors acting in concert for section 355(e) to apply.

In addition, the reference in the Conference Report to public offerings as transactions that could cause gain to be recognized under section 355(e) indicates Congress did not believe negotiations between the distributing corporation and an acquiror were necessary in order for an acquisition to be pursuant to a plan that included the distribution. Thus, to determine whether a plan of acquisition exists, one must look at all parties to the transaction, including the distributing and controlled corporations and their shareholders, not just the potential acquirors.

As enacted, section 355(e)(1) provides that the stock of a controlled corporation will not be qualified property under section 355(c)(2) or section 361(c)(2) if, under section 355(e)(2)(A), the stock is distributed as “part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.” Thus, if section 355(e)(1) applies to a distribution, the distributing corporation is taxed on the amount by which the distributed stock’s fair market value exceeds its basis. Distributee shareholders receive the controlled corporation stock tax free, but do not increase their bases to reflect the corporate level gain recognized by the distributing corporation on the distribution.

### *Explanation of Provisions*

The proposed regulations under section 355(e) provide guidance concerning the interpretation of the phrase “plan (or series of related transactions).” The proposed regulations also address the determination of the distributing corporation’s

gain when multiple controlled corporations are distributed and the distributions are part of a plan (or series of related transactions) pursuant to which a 50-percent or greater interest in one or more, but not all, of the distributed controlled corporations is acquired. The Department of the Treasury and the IRS plan to issue regulations addressing other issues arising under section 355(e), including aggregation and attribution rules (including provisions for public trading) and the administration of the statute of limitations provision of section 355(e)(4)(E). Comments concerning the proposed regulations and additional issues that should be addressed in regulations are welcome.

### A. Plan or Series of Related Transactions

Whether two transactions are part of the same “plan (or series of related transactions)” under section 355(e)(2)(A) is a subjective test, depending ultimately on the intentions and expectations of the relevant parties. As discussed above, indications are that Congress intended “plan (or series of related transactions)” to be interpreted broadly. Unlike the Administration Proposal and the Bills, which utilized the section 355(d) concept of “a person” (with aggregation) as the reference for relevant acquirors, the statute, as enacted, expanded the universe of transactions to which section 355(e) potentially applies by providing that the relevant acquirors could be “1 or more persons.” Also, the guidance in the Conference Report that public offerings of a sufficient size could trigger section 355(e) suggests that there does not necessarily have to be an identified acquiror on the date of the distribution for section 355(e) to apply, nor is the intent of the acquiror at the time of the distribution necessarily relevant in determining whether there is a plan.

The proposed regulations rely on a variety of factors to determine the existence of a plan (or series of related transactions) (hereinafter referred to as a “plan”). These factors include the business purpose or purposes for the distribution; the intentions of the parties; the existence of agreements, understandings, arrangements, or substantial negotiations; the timing of the transactions; the likelihood of an acquisition; and the causal connection between the distribution and the acquisition.

Congress specified one factor, temporal proximity, as affecting the determination of whether a plan exists. Specifically, section 355(e)(2)(B) provides a presumption that a plan exists if “1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution.” Accordingly, the proposed regulations provide that distributions within 2 years of an acquisition of the distributing corporation or a controlled corporation are presumed to be part of a plan. The proposed regulations outline the elements the distributing corporation must establish to rebut the statutory presumption.

## 1. Acquisitions on or After a Distribution

### General rebuttal

In the case of an acquisition occurring within 2 years after a distribution, the proposed regulations allow the distributing corporation to rebut the presumption by establishing by clear and convincing evidence that (i) the distribution was motivated in whole or substantial part by a corporate business purpose (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired) and (ii) the acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter. Decreasing “the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired” generally refers to transactions in which one business, a perceived takeover target, is separated from another via a stock distribution in an attempt to spare the other business from acquisition. Distributions intended to “decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired” are often difficult to differentiate from those intended to “facilitate an acquisition.” Both relate to a perceived pos-

sibility of acquisition and should receive similar treatment.

In this general rebuttal, the proposed regulations rely on corporate business purpose as a key factor indicating whether a distribution and an acquisition are part of a plan. Corporate business purpose is an important concept in the overall administration of section 355. The existence of a nonacquisition related corporate business purpose that prompted, in whole or substantial part, the distributing corporation to make the stock distribution suggests there is not a significant causal connection between the distribution and acquisition. The intent of the distributing corporation, the controlled corporation, or the controlling shareholders of either the distributing or controlled corporation to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired is relevant in determining the extent to which the distribution was motivated in whole or substantial part by another corporate business purpose within the meaning of §1.355-2. Analyzing whether there is another substantial corporate business purpose for the distribution in light of an acquisition-related purpose is similar to analyzing whether there is a corporate business purpose for a distribution in light of the potential avoidance of federal taxes. See §1.355-2(b)(1) and (5), Example 8. Thus, another business purpose must be real and substantial even in light of the acquisition business purpose.

The reliance on business purpose in the general rebuttal is consistent with the suggestions of many commentators writing about section 355(e), who identified corporate business purpose as an important factor in determining whether an acquisition and distribution are part of a plan.

### Alternative rebuttal

Reliance on a substantial nonacquisition business purpose as proof of no “plan” is appropriate when the distribution and acquisition are separated by a sufficient amount of time. Thus, the general rebuttal is not satisfied in certain cases, including where an acquisition occurs within 6 months after a distribution or where a distribution was not substan-

tially motivated by a corporate business purpose other than an intention to facilitate (or decrease the likelihood of) an acquisition. These acquisitions occur in circumstances more likely to indicate the existence of a plan at the time of the distribution. Thus, these acquisitions are subject to heightened scrutiny and will be considered part of a plan unless taxpayers satisfy a more stringent alternative rebuttal.

Unlike the general rebuttal, a nonacquisition business purpose alone is not sufficient under the alternative rebuttal. Rather, taxpayers must satisfy all prongs of a three-prong test.

The first prong of the alternative rebuttal may be satisfied in either of two ways. The distributing corporation must establish by clear and convincing evidence either that (i) at the time of the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders did not intend that one or more persons would acquire a 50-percent or greater interest in the distributing or any controlled corporation during the statutory presumption period (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) or (ii) the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in the distributing or controlled corporation. Clause (i) may be satisfied even in situations where one or more of the relevant parties intend that the distribution will facilitate an acquisition or acquisitions, so long as the parties do not intend that there be a 50-percent or greater change in ownership during the statutory presumption period. Alternatively, clause (ii) may be satisfied where the parties intend a 50-percent or greater change in ownership during the presumption period, provided that the parties do not intend that the distribution will facilitate any part of the acquisitions.

Under the second prong of the alternative rebuttal, the distributing corporation must establish by clear and convincing evidence that, at the time of the distribution, neither the distributing corporation, the controlled corporation, nor their controlling shareholders reasonably would have anticipated that it was more likely

than not that one or more persons would acquire a 50-percent or greater interest in the distributing corporation or the controlled corporation within 2 years after the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests if the distribution had not occurred.

This prong of the alternative rebuttal (hereinafter referred to as the “reasonable anticipation” test) incorporates two important concepts. First, it identifies reasonably anticipated acquisitions of the distributing or controlled corporation that would not have occurred but for the distribution and, because a causal connection exists between the two transactions, treats them as part of a plan. Second, it reflects the idea that reasonable anticipation, not just the presence of negotiations, is important in determining whether a plan exists. Considering reasonable anticipation of certain acquisitions is consistent with the legislative history. Though descriptions of the Administration Proposal included references to negotiations and distinctions between hostile and friendly acquisitions, the focus of section 355(e), as enacted, is whether a relationship exists between the distribution and the fact that persons other than the existing shareholders became owners of the distributing or controlled corporation.

A reasonable anticipation standard is necessary to implement section 355(e). Otherwise, a distributing corporation could attempt to avoid section 355(e) by distributing a controlled corporation under circumstances that virtually assure an acquisition of the distributing or controlled corporation, but arguing that, despite the imminence of the acquisition, effectuating the acquisition was not a motive for the distribution. A part of planning any transaction includes attempting to foresee actions others might take in response. Consistent with this business practice, it is appropriate, especially for acquisitions subject to heightened scrutiny, to require the distributing corporation to take into account the reasonably anticipated, likely actions of others to demonstrate that a distribution and acquisition are not part of a plan.

The second prong of the alternative rebuttal is not satisfied if, at the time of the

distribution, the relevant parties would reasonably anticipate that the distribution would give rise to *all of* an acquisition of a 50 percent interest in the distributing or controlled corporation. (The rebuttal is satisfied if the distributing corporation establishes by clear and convincing evidence that the relevant parties would not reasonably anticipate an acquisition of a 50 percent or greater interest *by persons who would not acquire such interests absent the distribution.*) This standard is to be contrasted with the first prong of the rebuttal, which is not satisfied if one or more of the relevant parties intended that there be a 50 percent or greater acquisition of distributing or controlled during the applicable time period, and the distribution is intended to facilitate *all or any part of* that acquisition. Because some acquisitions might be reasonably anticipated to occur without regard to whether the distribution takes place, the Department of the Treasury and the IRS believe that the distribution must be directly linked to all 50 percent of the acquisition to fail the “reasonable anticipation” test. However, a different result is called for where the relevant parties *intend* a 50 percent acquisition. In that case, it would appear that the aggregation of the various acquisitions comprising the 50 percent acquisition are themselves part of a single plan, so a distribution intended to facilitate only some of those acquisitions would be part of a plan also involving those other acquisitions not directly facilitated by the acquisition.

In developing the reasonable anticipation test, the Department of the Treasury and the IRS rejected suggestions by some commentators that serious negotiations or agreement with an acquiror need to have taken place at the time of distribution for a plan to exist. Requiring mutual agreement or negotiation is inappropriate because Congress intended the statute to apply in situations beyond those in which a distribution is made prior to and as part of an acquisition by a specifically identified acquiror. Section 355(e)(2)(B) makes clear that the section is intended to apply to acquisitions before and after a distribution. The legislative history also clarifies that a public offering after a distribution can trigger section 355(e) even though presumably no public buyer would have been negotiated with or even

identified at the time of the distribution. Because Congress intended distributions designed to facilitate public offerings to be covered, other transactions that are economically similar also should be covered. These transactions include a private placement of the distributing or controlled corporation’s stock or an auction of such stock by an investment banker. Like public offerings, these transactions do not necessarily involve predistribution negotiations or agreements regarding subsequent acquisitions and yet may still be part of the distributing or controlled corporation’s plan.

Thus, we believe that section 355(e) was intended to apply to a range of transactions, not limited to those in which a mutual agreement or negotiations relating to the acquisition occurred prior to the distribution. To require negotiations or agreements to be present prior to a distribution either would inappropriately exclude certain transactions from the coverage of the statute or would create a higher threshold for the existence of a plan in certain acquisitions than in other acquisitions.

The third prong of the alternative rebuttal reiterates a requirement in the general rebuttal. The distributing corporation must establish by clear and convincing evidence that the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired.

For purposes of applying the alternative rebuttal, the consequences of the application of section 355(e), directly or by indemnity, are disregarded in determining the intentions, motivations, and reasonable anticipations of the relevant parties. To do otherwise might give rise to a circularity in the application of the rules. If the consequences of the application of section 355(e) were relevant in determining such intentions, motivations, and reasonable anticipations, the distributing corporation could argue that objective evidence indicated that it would satisfy the alternative rebuttal, since arguably it would not be reasonable for an acquiror to act in a manner that would cause liability for tax under section 355(e). Conversely, the IRS could argue that the presence of an indemnity agreement indicated that the parties anticipated liability for tax under section 355(e).



## Acquisitions more than 2 years after a distribution

To prevent taxpayers from attempting to avoid the presumption period by delaying a planned acquisition beyond 2 years from the date of distribution, the proposed regulations provide that an acquisition occurring more than 2 years after the distribution is presumed part of a plan if there was an agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within 2 years thereafter. The distributing corporation may rebut the presumption using the general or alternative rebuttal discussed above. To provide certainty for transactions that, because of their separation in time, are unlikely to be part of a plan, the proposed regulations provide that, if there was no agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within 2 years thereafter, a distribution and an acquisition occurring more than 2 years afterwards are not part of a plan.

## 2. Acquisitions Before a Distribution

### Acquisitions within 2 years before a distribution

Section 355(e) also applies to transactions in which an acquisition of the distributing or controlled corporation's stock precedes a distribution of the controlled corporation. When the transactions being tested as part of a plan occur in this order, the most reliable indicators that a plan exists are an intent to make the distribution at the time of the acquisition and a causal connection between the acquisition and the distribution. In particular, if a person becomes a controlling shareholder by acquisition, that person's intention becomes the single best indicator of whether a later distribution was part of a plan. The proposed regulations allow a distributing corporation to rebut the presumption by establishing by clear and convincing evidence that, at the time of the acquisition, the distributing corporation and its controlling shareholders (determined immediately after the acquisition) did not intend to effectuate a distribution. Alternatively, the distributing corporation can rebut the presumption by establishing by clear and convincing evidence that the distribution would have occurred at approxi-

mately the same time and under substantially the same terms regardless of the acquisition (and, in the case of an issuance of stock, all acquisitions that are part of such issuance), unless a person acquiring an interest becomes a controlling shareholder by reason of the acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter).

### Acquisitions more than 2 years before a distribution

If an acquisition of an interest in the distributing corporation or the controlled corporation occurs more than 2 years before a distribution, the presumption shifts in favor of the taxpayer. The acquisition and the distribution are presumed not to be part of a plan unless the Commissioner can establish by clear and convincing evidence that, at the time of the acquisition, (i) the distributing corporation or its controlling shareholders intended to effectuate the distribution and (ii) that the distribution would not have occurred at approximately the same time and under substantially the same terms regardless of that acquisition (and, in the case of an issuance of stock, all acquisitions that are part of such issuance) or that a person acquiring an interest in that acquisition becomes a controlling shareholder by reason of that acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within six months thereafter). Because the passage of time makes it less likely that an acquisition and distribution are part of a plan, after two years the proposed regulations shift the burden of proof to the IRS to prove the existence of a plan. However, the proposed regulations do not allow a taxpayer to avoid section 355(e) by delaying the distribution when the distribution clearly was intended at the time of the acquisition.

## 3. Agreement, Understanding, Arrangement, or Substantial Negotiations

The proposed regulations do not define with precision the terms *agreement, un-*

*derstanding, arrangement, or substantial negotiations*. A binding contract is clearly included as an agreement, but, depending on all relevant facts and circumstances, parties can have an agreement, understanding, or arrangement even though they have not reached agreement on all terms. Under certain circumstances, such as in public offerings or auctions of the distributing or controlled corporation's stock by an investment banker, an agreement, understanding, arrangement, or substantial negotiations can take place regarding an acquisition even if the acquiror has not been specifically identified. The Department of the Treasury and the IRS are particularly interested in receiving comments regarding transactions that involve an investment banker and when contacts by the distributing corporation or the controlled corporation with an investment banker or contacts with potential acquirors by an investment banker on behalf of the distributing corporation or the controlled corporation should or should not be considered an agreement, understanding, arrangement, or substantial negotiations.

## 4. Options

The proposed regulations also treat certain options as agreements. If stock of the distributing or controlled corporation is acquired pursuant to an option, the option is treated as an agreement unless the distributing corporation establishes by clear and convincing evidence that, on the later of the date of distribution or issuance, the option was not more likely than not to be exercised. Generally, call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements, restricted stock, and any other instruments that provide for the right or possibility to issue, redeem, or transfer stock, cash settlement options, and other similar interests are treated as options. An option on an option is treated as an option under the proposed regulations. If there is an agreement, understanding, or arrangement to issue an option before the end of the 6 month period beginning on the date of the distribution, the option will be treated as issued on the date of the agreement, understanding, or arrangement. If an agreement, understanding, or arrangement to issue an

option is reached, or an option is issued, more than 6 months but not more than 2 years after the distribution, and there were substantial negotiations regarding the issuance of the option or the acquisition of the stock underlying the option before the end of the 6 month period beginning on the date of the distribution, the option will be treated as issued 6 months after the distribution. If there is an agreement, understanding, or an arrangement to issue an option more than 6 months but not more than 2 years after the distribution, and there were no substantial negotiations regarding the issuance of the option or the acquisition of the stock underlying the option before the end of the 6 month period beginning on the date of the distribution, the option will be treated as issued on the date of the agreement, understanding, or arrangement. The proposed regulations exempt certain options from treatment as options unless they are issued, transferred, or listed with a principal purpose of avoiding the application of section 355(e) or the proposed regulations. The enumerated exceptions cover certain commercially customary options unlikely to be used to avoid section 355(e) or the proposed regulations.

#### 5. Aggregating Acquisitions That are Pursuant to a Plan

Under the proposed regulations, each acquisition of stock of a distributing or controlled corporation must be tested to determine whether the acquisition is pursuant to a plan involving a distribution. Each acquisition of stock of a corporation acquired pursuant to a plan involving a distribution is aggregated with all acquisitions of stock of that corporation acquired pursuant to a plan involving that distribution to determine whether an acquisition of a 50-percent or greater interest as proscribed in section 355(e)(2)(A)(ii) has occurred.

#### B. Any Controlled Corporation

Section 355(e)(2)(A)(ii) provides that section 355(e)(1), which causes the distributing corporation to recognize its gain in the controlled corporation stock as if the distributing corporation had sold the stock for its fair market value, applies to any distribution to which section 355 applies and "which is part of a plan . . . pursuant to which 1 or more persons acquire

directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation *or any controlled corporation*" (emphasis added). A question has arisen concerning the measure of gain to the distributing corporation if, pursuant to a plan, the stock of more than one controlled corporation is distributed and stock representing a 50-percent or greater interest is acquired in some, but not all, of the distributed controlled corporations. The proposed regulations clarify that under those circumstances, the distributing corporation only recognizes gain on the stock of the distributed controlled corporations that were subject to 50-percent or greater acquisitions. If the distributing corporation is the acquired corporation, it must recognize gain on all of the distributed controlled corporations.

#### *Proposed Effective Date*

The regulations in this section are proposed to apply to distributions occurring after the regulations in this section are published as final regulations in the **Federal Register**.

#### *Special Analyses*

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### *Comments and Public Hearing*

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) and comments sent via the Internet that are submitted timely to the IRS. The IRS and the Department of the Treasury specifically request comments on the clar-

ity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 26, 2000, beginning at 10 a.m. in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by January 5, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### *Drafting Information*

The principal author of these proposed regulations is Brendan O'Hara, Office of the Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

#### *Proposed Amendments to the Regulations*

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.355-7 also issued under 26 U.S.C. 355(e)(5). \* \* \*

Par. 2. Section 1.355-0 is amended by revising the section heading and adding introductory text and an entry for §1.355-7 to read in part as follows:

*§1.355-0 Outline of sections.*

In order to facilitate the use of §§1.355-1 through 1.355-7, this section lists the major paragraphs in those sections as follows:

\* \* \* \* \*

*§1.355-7 Recognition of gain on certain distributions of stock or securities in connection with an acquisition.*

- (a) Plan or series of related transactions.
  - (1) In general.
  - (2) Distributions within 2 years of an acquisition.
    - (i) Presumption.
    - (ii) Rebuttal for acquisitions after a distribution.
  - (iii) Alternative rebuttal for acquisitions on or after a distribution.
  - (iv) Operating rules for paragraph (a)(2)(iii) of this section.
  - (v) Rebuttals for acquisitions before a distribution.
- (A) General rebuttal.
- (B) Alternative rebuttal.
- (3) Distributions more than 2 years from an acquisition.
  - (i) Acquisitions after a distribution.
  - (ii) Acquisitions before a distribution.
- (4) Controlling shareholder.
- (5) Agreement, understanding, or arrangement.
- (6) Multiple acquisitions.
- (7) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests.
  - (i) Treatment of options.
- (A) General rule.
- (B) Agreement, understanding, arrangement, or substantial negotiations to issue an option.
- (ii) Instruments treated as options.
- (iii) Instruments generally not treated as options.
- (A) Escrow, pledge, or other security agreements.
- (B) Compensatory options.
- (C) Options exercisable only upon death, disability, mental incompetency, or retirement.

(D) Rights of first refusal.

(E) Other enumerated instruments.

(8) Examples.

(b) Multiple controlled corporations.

(c) Valuation.

(d) Effective date.

Par. 3. Section 1.355-7 is added to read as follows:

*§1.355-7 Recognition of gain on certain distributions of stock or securities in connection with an acquisition—(a) Plan or series of related transactions—(1) In general.* (i) Except as provided in section 355(e) and in this section, section 355(e) applies to any distribution—

(A) To which section 355 (or so much of section 356 as relates to section 355) applies; and

(B) Which is part of a plan (or series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

(ii) For purposes of this section, a controlled corporation is a corporation the stock of which is distributed in a distribution to which section 355 applies.

(iii) The existence of a plan (or series of related transactions) does not depend on whether or not more than one person acts in concert.

(2) *Distributions within 2 years of an acquisition—(i) Presumption.* If a distribution occurs within 2 years of an acquisition by one or more persons of an interest in the distributing corporation or any controlled corporation, the distribution and that acquisition are presumed to be part of a plan (or series of related transactions).

(ii) Rebuttal for acquisitions after a distribution. (A) In the case of an acquisition occurring after a distribution, the distributing corporation may rebut the presumption of paragraph (a)(2)(i) of this section by establishing by clear and convincing evidence that—

(1) The distribution was motivated in whole or substantial part by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired); and

(2) The acquisition occurred more than 6 months after the distribution and there

was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter.

(B) The intent of the distributing corporation, the controlled corporation, or the controlling shareholders of either the distributing or controlled corporation to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired is relevant in determining the extent to which the distribution was motivated by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired).

(iii) *Alternative rebuttal for acquisitions on or after a distribution.* In the case of an acquisition occurring on or after a distribution, the distributing corporation also may rebut the presumption of paragraph (a)(2)(i) of this section by establishing by clear and convincing evidence that—

(A)(1) At the time of the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders did not intend that one or more persons would acquire a 50-percent or greater interest in the distributing or any controlled corporation during the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter); or

(2) The distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in the distributing or controlled corporation; and

(B) At the time of the distribution, neither the distributing corporation, the controlled corporation, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in the distributing corporation or the controlled corporation within 2 years after the distribution (or later pursuant to an agreement, understanding, or arrangement existing at



the time of the distribution or within 6 months thereafter) who would not have acquired such interests if the distribution had not occurred; and

(C) The distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired.

(iv) *Operating rules for paragraph (a)(2)(iii) of this section.* (A) For purposes of paragraph (a)(2)(iii)(A)(I) of this section, if an acquisition by one or more persons of an interest in the distributing corporation or any controlled corporation before the distribution is part of a plan (or series of related transactions) involving the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders must include the amount of stock acquired in that acquisition as an amount they intended at the time of the distribution to be acquired during the 2-year period beginning on the date of the distribution.

(B) For purposes of paragraph (a)(2)-(iii)(B) of this section, persons who more likely than not would have acquired interests in the distributing corporation if the distribution had not occurred are also treated as persons who more likely than not would have acquired proportionate interests in the controlled corporation if the distribution had not occurred. No other persons are treated as persons who would have acquired interests in the controlled corporation if the distribution had not occurred.

(C) For purposes of paragraph (a)(2)-(iii)(B) of this section, if an acquisition by one or more persons of an interest in the distributing corporation or any controlled corporation before the distribution is part of a plan (or series of related transactions) involving the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders must treat the amount of stock acquired in that acquisition as an amount they would reasonably have anticipated was more likely than not to be acquired within 2 years after the distribution that would not have been acquired if the distribution had not occurred.

(D) For purposes of determining the intentions, motivations, and reasonable an-

ticipations of the relevant parties under paragraph (a)(2)(iii) of this section, the consequences of the application of section 355(e), directly or by indemnity, are disregarded.

(v) *Rebuttals for acquisitions before a distribution—(A) General rebuttal.* In the case of an acquisition occurring before a distribution, the distributing corporation may rebut the presumption of paragraph (a)(2)(i) of this section by establishing by clear and convincing evidence that, at the time of the acquisition, the distributing corporation and its controlling shareholders (determined immediately after the acquisition) did not intend to effectuate a distribution.

(B) *Alternative rebuttal.* In the case of an acquisition occurring before a distribution, the distributing corporation may rebut the presumption of paragraph (a)(2)(i) of this section by establishing by clear and convincing evidence that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of that acquisition (and, in the case of an issuance of stock, all acquisitions that are part of such issuance), provided no person acquiring an interest in that acquisition becomes a controlling shareholder by reason of that acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter).

(3) *Distributions more than 2 years from an acquisition—(i) Acquisitions after a distribution.* (A) If an acquisition by one or more persons of an interest in the distributing corporation or any controlled corporation occurs more than 2 years after a distribution, the distribution and that acquisition are presumed part of a plan (or series of related transactions) only if there was an agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within 2 years thereafter. The distributing corporation may rebut the presumption under paragraph (a)(2)(ii) or (a)(2)(iii) of this section.

(B) If an acquisition by one or more persons of an interest in the distributing corporation or any controlled corporation

occurs more than 2 years after a distribution, and there was no agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within 2 years thereafter, the acquisition and the distribution are not part of a plan (or series of related transactions).

(ii) *Acquisitions before a distribution.* If an acquisition by one or more persons of an interest in the distributing corporation or the controlled corporation occurs more than 2 years before a distribution, the acquisition and the distribution are not part of a plan (or series of related transactions) unless the Commissioner can establish by clear and convincing evidence that—

(A) At the time of the acquisition, the distributing corporation or its controlling shareholders (determined immediately after the acquisition) intended to effectuate the distribution; and

(B)(I) The distribution would not have occurred at approximately the same time and under substantially the same terms regardless of that acquisition (and, in the case of an issuance of stock, all acquisitions that are part of such issuance); or

(2) A person acquiring an interest in that acquisition becomes a controlling shareholder by reason of that acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter).

(4) *Controlling shareholder.* For purposes of paragraphs (a)(2) and (3) of this section, a controlling shareholder is any person who, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)), possesses voting power in the distributing or controlled corporation representing a meaningful voice in the governance of the corporation. A controlling shareholder of a publicly traded corporation is any person who, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)), owns 5 percent or more of any class of stock of the distributing or controlled corporation and who actively participates in the management or operation of the corporation. If a distribution precedes an acquisition, the controlled corporation's controlling

shareholders immediately after the distribution are considered the controlled corporation's controlling shareholders at the time of the distribution.

(5) *Agreement, understanding, or arrangement.* For purposes of this section, the parties do not necessarily have to have entered into a binding contract or have reached agreement on all terms to have an "agreement, understanding, or arrangement."

(6) *Multiple acquisitions.* Each acquisition of stock of a corporation acquired pursuant to a plan (or series of related transactions) involving a distribution will be aggregated with all acquisitions of stock of that corporation acquired pursuant to a plan (or series of related transactions) involving that distribution to determine whether an acquisition described in section 355(e)(2)(A)(ii) occurred. The appropriate presumption and rules for rebuttal will be applied to each acquisition depending on when the acquisition occurred.

(7) *Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests*—(i) *Treatment of options*—(A) *General rule.* For purposes of this section, if stock of the distributing or controlled corporation is acquired pursuant to an option, the option will be treated as an agreement on the date of issuance unless the distributing corporation establishes by clear and convincing evidence that, on the later of the date of distribution or date of issuance, the option was not more likely than not to be exercised. The determination of whether an option was more likely than not to be exercised is based on all the facts and circumstances. In applying the previous sentence, the fair market value of stock underlying an option is determined by taking into account control premiums and minority and blockage discounts.

(B) *Agreement, understanding, arrangement, or substantial negotiations to issue an option.* If there is an agreement, understanding, or arrangement to issue an option before the end of the 6-month period beginning on the date of the distribution, the option will be treated as issued on the date of the agreement, understanding, or arrangement. If an agreement, understanding, or arrangement to issue an option is reached, or an option is issued, more than 6 months but not more than 2 years after the distribution, and there were

substantial negotiations regarding the issuance of the option or the acquisition of the stock underlying the option before the end of the 6-month period beginning on the date of the distribution, the option will be treated as issued 6 months after the distribution. If there is an agreement, understanding, or an arrangement to issue an option more than 6 months but not more than 2 years after the distribution, and there were no substantial negotiations regarding the issuance of the option or the acquisition of the stock underlying the option before the end of the 6 month period beginning on the date of the distribution, the option will be treated as issued on the date of the agreement, understanding, or arrangement.

(ii) *Instruments treated as options.* For purposes of this paragraph (a)(7), except to the extent provided in paragraph (a)(7)(iii) of this section, call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements (including rights to cause the redemption of stock), restricted stock, any other instruments that provide for the right or possibility to issue, redeem, or transfer stock (including an option on an option), cash settlement options, or any other similar interests are treated as options.

(iii) *Instruments generally not treated as options.* For purposes of this paragraph (a)(7), the following are not treated as options unless issued, transferred (directly or indirectly), or listed with a principal purpose of avoiding the application of section 355(e) or this section:

(A) *Escrow, pledge, or other security agreements.* An option that is part of a security arrangement in a typical lending transaction (including a purchase money loan), if the arrangement is subject to customary commercial conditions. For this purpose, a security arrangement includes, for example, an agreement for holding stock in escrow or under a pledge or other security agreement, or an option to acquire stock contingent upon a default under a loan.

(B) *Compensatory options.* An option to acquire stock in the distributing or controlled corporation with customary terms and conditions provided to an employee or director in connection with the performance of services for the corporation or a person related to it under section

355(d)(7)(A) (and that is not excessive by reference to the services performed) and that immediately after the distribution and within 6 months thereafter—

(1) Is nontransferable within the meaning of §1.83-3(d); and

(2) Does not have a readily ascertainable fair market value as defined in §1.83-7(b).

(C) *Options exercisable only upon death, disability, mental incompetency, or retirement.* Any option entered into between stockholders of a corporation (or a stockholder and the corporation) that is exercisable only upon the death, disability, or mental incompetency of the stockholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), the stockholder's retirement.

(D) *Rights of first refusal.* A bona fide right of first refusal regarding the corporation's stock with customary terms, entered into between stockholders of a corporation (or between the corporation and a stockholder).

(E) *Other enumerated instruments.* Any other instruments specified in regulations, a revenue ruling, or a revenue procedure. See §601.601(d)(2) of this chapter.

(8) *Examples.* The following examples illustrate this paragraph (a). Throughout these examples, assume that the distributing corporation (D) owns all of the stock of the controlled corporation (C). Assume further that D distributes the stock of C in a distribution to which section 355 applies and to which section 355(d) does not apply. For purposes of these examples, unless otherwise stated, assume that all transactions described are respected under applicable general tax principles. No inference should be drawn from any example concerning whether any requirements of section 355 other than those of section 355(e) are satisfied. The examples are as follows:

*Example 1.* To facilitate a stock offering by D of 50 percent of its stock, D distributes C pro rata to its shareholders. D issues new shares amounting to 50 percent of its stock to the public in a public offering within 6 months of the distribution. Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Because

the acquisition occurred within 6 months after the distribution, D must rely on the rules of paragraph (a)(2)(iii) of this section to rebut the presumption. D will not be able to rebut the presumption because D cannot establish either that D did not intend that one or more persons would acquire a 50-percent or greater interest in D during the relevant period under paragraph (a)(2)(iii)(A)(1) of this section or that the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in D under paragraph (a)(2)(iii)(A)(2) of this section. Because the presumption of paragraph (a)(2)(i) of this section cannot be rebutted regarding the acquisition of a 50-percent or greater interest in D, section 355(e) applies to the distribution of C.

**Example 2.** (i) X corporation announces an intention to acquire D, principally to acquire C's business. Due to market conditions, X's available capital, and X's success in acquiring other corporations, D would reasonably anticipate that an acquisition of a 50-percent or greater interest in D is more likely than not to occur within 2 years. To lower its financing costs and, in substantial part, to deter the acquisition of D (by separating it from the more attractive C), D distributes C pro rata to the D shareholders. X acquires C within 6 months of the distribution.

(ii) Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Because the acquisition occurred within 6 months after the distribution, D must rely on the rules of paragraph (a)(2)(iii) of this section to rebut the presumption. Under paragraph (a)(2)(iii)(A)(2) of this section, D will be able to establish that the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in D or C. Under paragraph (a)(2)(iv)(B) of this section, for purposes of paragraph (a)(2)(iii)(B) of this section, persons who more likely than not would have acquired interests in D if the distribution had not occurred are also treated as persons who more likely than not would have acquired proportionate interests in C if the distribution had not occurred. Therefore, under paragraph (a)(2)(iii)(B) of this section, D will be able to establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D or C within 2 years after the distribution who would not have acquired such interests if the distribution had not occurred.

(iii) Under paragraph (a)(2)(iii)(C) of this section, D will not be able to establish that the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of D's business by separating it from the C business that was likely to be acquired. Because the presumption of paragraph (a)(2)(i) of this section cannot be rebutted regarding the acquisition by X of a 50-percent or greater interest in C, section 355(e) applies to the distribution of C.

**Example 3.** The facts are the same as *Example 2* except the acquisition takes place 1 year after the distribution. The parties had not reached an agreement, understanding, or arrangement concerning, and had not substantially negotiated, the acquisition of C stock within 6 months after the distribution. Under paragraph (a)(2)(i) of this section, the distribu-

tion and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Under paragraph (a)(2)(ii)(B) of this section, D's intent to deter an acquisition of D is a factor tending to disprove that the distribution was motivated in substantial part by the desire to lower its financing costs. If D can establish by clear and convincing evidence that the distribution was nonetheless motivated in substantial part by the need to lower its financing costs, D can rebut the presumption using paragraph (a)(2)(ii) of this section. D will not be able to rebut the presumption by using the alternative rebuttal under paragraph (a)(2)(iii) of this section for the same reason as in *Example 2*.

**Example 4.** D is a widely held, publicly traded corporation. D distributes C pro rata to D's shareholders. By contract, C agrees to indemnify D for any imposition of tax under section 355(e). The distribution is motivated solely by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired). At the time of the distribution, although D has not been approached by any potential acquirors of C, D would reasonably anticipate that, under current market conditions, if C is separated from D, an acquisition of a 50-percent or greater interest in C is more likely than not to occur within 2 years by persons who would not have acquired a proportionate interest in D if the distribution of C had not occurred. C is acquired within 6 months after the distribution. Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Because the acquisition occurred within 6 months after the distribution, D must rely on the rules of paragraph (a)(2)(iii) of this section to rebut the presumption. D will be able to establish that the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in D or C under paragraph (a)(2)(iii)(A)(2) of this section. However, D will not be able to establish the requirements of paragraph (a)(2)(iii)(B) of this section. Under paragraph (a)(2)(iv)(B) of this section, for purposes of paragraph (a)(2)(iii)(B) of this section, only persons who more likely than not would have acquired interests in D if the distribution had not occurred are treated as persons who more likely than not would have acquired proportionate interests in C if the distribution had not occurred. Therefore, under paragraph (a)(2)(iii)(B) of this section, D will not be able to establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D or C within 2 years after the distribution who would not have acquired such interests if the distribution had not occurred. Under paragraph (a)(2)(iv)(D) of this section, the consequences of the indemnity agreement are disregarded for purposes of applying paragraph (a)(2)(iii)(B) of this section. Because the presumption of paragraph (a)(2)(i) of this section cannot be rebutted regarding the acquisition of a 50-percent or greater interest in C, section 355(e) applies to the distribution of C.

**Example 5.** (i) D believes it would be a more attractive acquisition candidate if it did not own C. To achieve significant nontax cost savings and, in substantial part, to maximize the possibility of D's acquisition, D distributes C pro rata. At the time of the distribution, D has not, directly or indirectly, solicited or received any indication of interest from potential acquirors. At the end of 6 months after the distribution, no agreement, arrangement, understanding, or substantial negotiations regarding the acquisition of D have taken place. Seven months after the distribution, D engages an investment banker to conduct an auction of D. One of the bidders acquires D 1 year after the distribution. Under paragraph (a)(2)(i) of this section, the distribution and acquisition are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. Because there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter, D can use the rebuttal under paragraph (a)(2)(ii) of this section if D can establish that the distribution was motivated in whole or substantial part by the corporate business purpose of achieving significant nontax cost savings. Under paragraph (a)(2)(ii)(B) of this section, D's intent to facilitate an acquisition of D is a factor tending to disprove that the distribution was motivated in substantial part by the desire to achieve nontax cost savings. If D can establish by clear and convincing evidence that the distribution was nonetheless motivated in substantial part by the need to achieve nontax cost savings for D and C, D can rebut the presumption using paragraph (a)(2)(ii) of this section.

(ii) D cannot rebut the presumption using the rules of paragraph (a)(2)(iii) of this section because D cannot establish either that D did not intend that one or more persons would acquire a 50-percent or greater interest in D during the relevant period under paragraph (a)(2)(iii)(A)(1) of this section or that the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in D under paragraph (a)(2)(iii)(A)(2) of this section.

**Example 6.** D announces that it will distribute C pro rata to D's shareholders. The distribution is motivated solely by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired). After the announcement but before the distribution, D acquires X, a widely held corporation. The X shareholders receive D stock in exchange for their X stock. No person who acquired D stock in the X acquisition became a controlling shareholder of D, as defined in paragraph (a)(4) of this section, within the time period described in paragraph (a)(2)(v)(B) of this section. Under paragraph (a)(2)(i) of this section, the distribution and the acquisition of D stock by the X shareholders are presumed to be part of a plan (or series of related transactions) because the acquisition occurred within 2 years of the distribution. If D can establish by clear and convincing evidence that the distribution of C would have occurred at approximately the same time and under substantially the same terms regardless of the acquisition of X, D may rebut the presumption under paragraph (a)(2)(v)(B) of this section.



*Example 7.* (i) D engages in business 1. C engages in business 2. D is interested in expanding business 1 through acquisitions, but D's ownership of C has been an impediment to acquisitions using D stock. On the advice of its investment banker, D plans to distribute its C stock to its shareholders solely to facilitate acquisitions by D. D has no specific goals regarding how much D stock will be acquired after the distribution. D and its investment banker have identified X and Y as potential acquisition targets. After D decides to distribute its C stock, but before the distribution date, D negotiates with and acquires X, but has no contact with Y. A, X's sole shareholder, receives 30 percent of D's stock, becoming a controlling shareholder of D within the meaning of paragraph (a)(4) of this section. One year after the distribution, D acquires Y. Y's shareholders receive 19 percent of D's stock. After the distribution, D and its investment banker identify Z as another desirable target. Eighteen months after the distribution, D acquires Z. Z's shareholders receive 17 percent of D's stock.

(ii) Under paragraph (a)(2)(i) of this section, the distribution and each acquisition are presumed to be part of a plan (or series of related transactions) because each acquisition occurred within 2 years of the distribution. In addition, under paragraph (a)(6) of this section, all acquisitions for which the presumption is not rebutted are aggregated to determine whether an acquisition described in section 355(e)(2)(A)(ii) has occurred.

(iii) Regarding the acquisition of X, D will not be able to rebut the presumption under paragraph (a)(2)(v)(A) of this section because D cannot establish that at the time A acquired D stock, D did not intend to effectuate a distribution. In addition, D cannot rebut the presumption under paragraph (a)(2)(v)(B) of this section because that paragraph does not apply to an acquisition in which a person becomes a controlling shareholder.

(iv) Regarding the acquisitions of Y and Z, D will not be able to rebut the presumption under paragraph (a)(2)(ii)(A) of this section because D cannot establish that the distribution was motivated in whole or substantial part by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired).

(v) To rebut the presumption with regard to each acquisition of Y and Z using the alternative rebuttal of paragraph (a)(2)(iii) of this section, D must establish three facts. First, under paragraph (a)(2)(iii)(A)(I) of this section, D must establish that, at the time of the distribution, D and its controlling shareholders did not intend that one or more persons would acquire a 50-percent or greater interest in D or C during the presumption period described in that paragraph. For that purpose, the interests intended to be acquired in D or C will include A's acquisition of D stock under paragraph (a)(2)(iv)(A) of this section. Second, under paragraph (a)(2)(iii)(B) of this section, D must establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D or C within 2 years after the distribution (or later

pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests if the distribution had not occurred. Under paragraph (a)(2)(iv)(C) of this section, D, C, and their controlling shareholders must treat the amount of D stock acquired by A as an amount they would reasonably have anticipated was more likely than not to be acquired within 2 years after the distribution that would not have been acquired if the distribution had not occurred. Third, under paragraph (a)(2)(iii)(C) of this section, D will be able to establish that the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired.

*Example 8.* D plans to distribute C pro rata to its shareholders. The distribution is substantially motivated by a corporate business purpose within the meaning of §1.355-2(b) (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired). After the announcement date, D's investment banker informs D's management that there is a lot of interest in new investment in D now that it will no longer own C. At the time of the distribution, D would reasonably anticipate that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D within 2 years (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not acquire such interests absent the distribution. Three months after the distribution, D issues an option to X to purchase 50 percent of the D stock. At the time of issuance, the facts and circumstances indicate that the option is more likely than not to be exercised. Two years after issuance, X exercises the option and purchases 50 percent of the D stock. Under paragraph (a)(7)(i)(A) of this section, the option is treated as an agreement on the date it is issued. Under paragraph (a)(3)(i)(A) of this section, the distribution and the acquisition are presumed to be part of a plan (or series of related transactions) because there was an agreement concerning the acquisition within 2 years of the distribution. D will not be able to rebut the presumption using the rebuttals of paragraphs (a)(2)(ii) or (a)(2)(iii) of this section. The rebuttal of paragraph (a)(2)(ii) of this section is unavailable because there was an agreement concerning the acquisition within 6 months of the distribution. The rebuttal of paragraph (a)(2)(iii) of this section is unavailable because D cannot establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D within 2 years (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests absent the distribution. Because the presumption relating to the acquisition of a 50-percent interest in D cannot be rebutted, section 355(e) applies to the distribution of C.

*Example 9.* (i) D distributes C pro rata to its shareholders solely to facilitate a stock offering by

C. To take advantage of favorable market conditions, C issues new shares amounting to 20 percent of its stock in a public offering followed 1 month later by the distribution. The public offering documents disclosed the intended distribution of C. Neither D, C, nor their controlling shareholders intended any further transactions involving D or C stock. In addition, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably anticipate that it was more likely than not that one or more persons would acquire a 50-percent interest in D or C within 2 years (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within 6 months thereafter) who would not have acquired such interests absent the distribution. Two months after the distribution, C is approached unexpectedly regarding an opportunity to acquire X. Five months after the distribution, C acquires X in exchange for 40 percent of the C stock. Under paragraph (a)(2)(i) of this section, the distribution and each acquisition are presumed to be part of a plan (or series of related transactions) because each acquisition occurred within 2 years of the distribution.

(ii) Regarding the public offering, D cannot rebut the presumption using paragraph (a)(2)(v) of this section. At the time of the acquisition, D and its controlling shareholders intended to effectuate the distribution. Also, the distribution would not have occurred at approximately the same time and under substantially the same terms regardless of the public offering.

(iii) Regarding C's acquisition of X, D will not be able to rebut the presumption using paragraph (a)(2)(ii) of this section because the acquisition occurred within 6 months after the distribution. However, D will be able to rebut the presumption regarding the acquisition of X using paragraph (a)(2)(iii) of this section. Neither D, C, nor their controlling shareholders intended that one or more persons would acquire a 50-percent or greater interest in D or C during the relevant period under paragraph (a)(2)(iii)(A)(I) of this section. Under paragraph (a)(2)(iii)(B) of this section, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in C within 2 years who would not have acquired such interests if the distribution had not occurred. Under paragraph (a)(2)(iii)(C) of this section, the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired. Because only the 20-percent acquisition by public offering is part of a plan (or series of related transactions) involving the distribution, section 355(e) does not apply.

*(b) Multiple controlled corporations.* Only the stock or securities of a controlled corporation in which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest as part of a plan (or series of related transactions) involving the distribution of that corporation will be treated as

not qualified property under section 355(e)(1) if—

(1) The stock or securities of more than one controlled corporation are distributed in distributions to which section 355 applies; and

(2) One or more persons do not acquire, directly or indirectly, stock representing a 50-percent or greater interest in the distributing corporation pursuant to a plan (or series of related transactions) involving any of those distributions.

(c) *Valuation.* Except as provided in paragraph (a)(7)(i)(A) of this section, for purposes of section 355(e) and this section, all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(d) *Effective date.* The regulations in this section apply to distributions occurring after the regulations in this section are published as final regulations in the **Federal Register**.

Robert E. Wenzel,  
*Deputy Commissioner of  
Internal Revenue.*

(Filed by the Office of the Federal Register on August 19, 1999, 1:37 p.m., and published in the issue of the Federal Register for August 24, 1999, 64 F.R. 46155)

## Notice of Proposed Rulemaking

### Private Foundation Disclosure Rules

**REG-121946-98**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the regulations relating to the public disclosure requirements described in section 6104(d) of the Internal Revenue Code. The proposed regulations implement changes made by the Tax and Trade Relief Extension Act of 1998, which extended fully to private foundations the same rules regarding public disclosure of annual information returns that apply to other tax-exempt orga-

nizations. The proposed regulations provide guidance for private foundations required to make copies of applications for tax exemption and annual information returns available for public inspection and to comply with requests for copies of those documents. Final regulations relating to the public disclosure requirements applicable to tax-exempt organizations other than private foundations were issued on April 9, 1999.

DATES: Written or electronic comments and requests for a public hearing must be received by October 12, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-121946-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-121946-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at <http://www.irs.ustreas.gov/taxregs/reglist.html>.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Michael B. Blumenfeld, (202) 622-6070 (not a toll-free number); concerning submissions of comments, LaNita Van Dyke (202) 622-7190 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### *Paperwork Reduction Act*

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP,

Washington, DC 20224. Comments on the collections of information should be received by October 12, 1999. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in these proposed regulations are in §§301.6104(d)-1, 301.6104(d)-2, and 301.6104(d)-3. This information is required to enable a private foundation to comply with section 6104(d) of the Internal Revenue Code (Code). Under section 6104(d), a private foundation is required to make its application for tax exemption and its annual information returns available for public inspection. In addition, a private foundation is required to comply with requests made in person or in writing from individuals who seek a copy of those documents or, in the alternative, to make its documents widely available. The requirement that a private foundation make its application for tax exemption and annual information returns available for public inspection and comply with requests made in person or in writing from individuals who seek a copy of those documents or, in the alternative, make the documents widely available, will enable the public to obtain information about the private foundation. Under section 6104(d), a private foundation is permitted to file an application for relief from the requirement to provide copies if the private foundation reasonably believes it is the subject of a harassment campaign. The information a private foundation provides when filing an application for a de-

termination that it is subject to a harassment campaign will be used by the IRS to make such determination. The collection of information is required to obtain relief from the requirement to comply with requests for copies if such requests are part of the harassment campaign. The likely respondents and/or recordkeepers are private foundations. The burden for recordkeeping and for reporting is reflected below.

Estimated total annual recordkeeping burden: 32,565 hours.

Estimated average annual burden per recordkeeper: 30 minutes.

Estimated number of recordkeepers: 65,065.

Estimated total annual reporting burden: 31 hours.

Estimated average annual reporting burden per respondent: 27 minutes.

Estimated number of respondents: 68.

Estimated annual frequency of responses: on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### *Background*

This document proposes to amend §§301.6104(d)–1 through 301.6104(d)–5 of the Procedure and Administration Regulations (26 CFR Part 301) relating to the section 6104(d) public disclosure requirements applicable to tax-exempt organizations (organizations described in section 501(c) or (d) and exempt from taxation under section 501(a)). The proposed amendments would remove existing §301.6104(d)–1 (relating to public inspection of private foundation annual information returns). The proposed amendments also would revise §§301.6104(d)–2 through 301.6104(d)–5 to apply the provisions to all tax-exempt organizations, including private foundations, and redesignate existing §§301.6104(d)–2 through 301.6104(d)–5 as §§301.6104(d)–0

through 301.6104(d)–3, respectively. This regulation is not subject to the Unfunded Mandates Reform Act of 1995 because the regulation is an interpretive regulation.

### *Description of Current Law Disclosure Requirements Applicable to Private Foundations*

Section 6104(d), as in effect prior to the effective date of the Tax and Trade Relief Extension Act of 1998 (Division J of H.R. 4328, the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999)(Public Law 105-277, 112 Stat 2681) (with respect to private foundations), requires a private foundation to make its annual information returns available for public inspection at its principal office during regular business hours for a period of 180 days after the foundation publishes notice of the availability of its return. A private foundation must publish such notice not later than the due date of the return (determined with regard to any extension of time for filing) in a newspaper having general circulation in the county in which the principal office of the foundation is located. Section 6104(e), as in effect prior to the effective date of the Tax and Trade Relief Extension Act of 1998 (with respect to private foundations), requires a private foundation to allow public inspection of the foundation's application for recognition of exemption at the foundation's principal office (and certain regional or district offices). Section 6104(e) also requires a private foundation to provide copies of its exemption application upon request. However, the requirement to provide copies of an exemption application upon request becomes effective only after the Secretary of the Treasury issues regulations applicable to private foundations describing how a private foundation may be relieved of the obligation to provide copies in response to requests by making its exemption application widely available or by obtaining an IRS determination that a particular request is part of a harassment campaign.

### *Amendments Made by the Tax and Trade Relief Extension Act of 1998*

The Tax and Trade Relief Extension Act of 1998, which was enacted on October 21, 1998, amended section 6104(e) of

the Code to subject the annual information returns filed by private foundations to the same rules regarding public disclosure that apply to other tax-exempt organizations. In addition, the Tax and Trade Relief Extension Act of 1998 repealed existing section 6104(d), and redesignated section 6104(e), as amended, as new section 6104(d). Section 6104(d), as amended by the Tax and Trade Relief Extension Act of 1998, requires each tax-exempt organization, including one that is a private foundation, to allow public inspection at its principal office (and at certain regional or district offices) and to comply with requests, made either in person or in writing, for copies of the organization's application for recognition of exemption and the organization's three most recent annual information returns. Congress appears to have intended that nonexempt charitable trusts described in section 4947(a)(1) and nonexempt private foundations comply with the expanded public disclosure requirements, just as such entities are subject to the information reporting requirements of section 6033 pursuant to section 6033(d). See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1998 (JCS-6-98), November 24, 1998, at 242, fn. 102.

The Tax and Trade Relief Extension Act of 1998 amendments apply to requests made after the later of December 31, 1998, or the 60th day after the Secretary of the Treasury issues regulations referred to in section 6104(d)(4) (relating to when documents are made widely available and when a particular request is considered part of a harassment campaign). On April 9, 1999, the IRS published in the **Federal Register** (64 F.R. 17279 [T.D. 8818, 1999–17 I.R.B. 3]) final regulations under section 6104(d) applicable to tax-exempt organizations other than private foundations. Accordingly, section 6104(d), as amended by the Tax and Trade Relief Extension Act of 1998, became effective with respect to tax-exempt organizations other than private foundations on June 8, 1999.

### *Explanation of Provisions*

The proposed amendments extend the recently-published final regulations under section 6104(d) to apply to private founda-



dations. The proposed amendments also modify those regulations in several respects. The proposed amendments state that the term annual information return includes any return that is required to be filed under section 6033. For a private foundation, such returns include Form 990-PF and Form 4720. Consistent with the statute, the proposed amendments provide that, unlike other tax-exempt organizations, a private foundation is required to disclose to the general public the names and addresses of its contributors. The proposed amendments also clarify that, for purposes of section 6104(d), the terms tax-exempt organization and private foundation include nonexempt private foundations and nonexempt charitable trusts described in section 4947(a)(1) that are subject to the information reporting requirements of section 6033. Finally, the proposed amendments remove existing §301.6104(d)-1 and redesignate existing §§301.6104-2 through 301.6104(d)-5, as §§301.6104(d)-0 through 301.6104(d)-3, respectively.

Until 60 days after these proposed amendments are published as final regulations in the **Federal Register**, private foundations continue to be subject to section 6104(d) and section 6104(e), as in effect prior to the Tax and Trade Relief Extension Act of 1998, and existing §301.6104(d)-1. Thereafter, private foundations will continue to be subject to the public inspection requirements of section 6104(d), as in effect prior to the Tax and Trade Relief Extension Act of 1998, and existing §301.6104(d)-1 with respect to any annual information return the due date (determined with regard to any extension of time for filing) for which is prior to the effective date of the final regulations.

#### *Proposed Effective Date*

The amendments made by these regulations are proposed to be effective 60 days after the date these regulations are published as final regulations in the **Federal Register**.

#### *Special Analyses*

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Pursuant to

sections 603(a) and 605(b) of the Regulatory Flexibility Act, it is certified that the collection of information referenced in this notice of proposed rulemaking will not have a significant economic impact on a substantial number of small entities. Although a substantial number of small entities will be subject to the collection of information requirements in these regulations, the requirements will not have a significant economic impact on these entities. The average time required to maintain and disclose the information required under these regulations is estimated to be 30 minutes for each private foundation. This estimate is based on the assumption that, on average, a private foundation will receive one request per year to inspect or provide copies of its application for tax exemption and its annual information returns. Approximately 0.1 percent of the private foundations affected by these regulations will be subject to the reporting requirements contained in the regulations. It is estimated that annually, approximately 65 private foundations will make its documents widely available by posting them on the Internet. In addition, it is estimated that annually, approximately 3 private foundations will file an application for a determination that they are the subject of a harassment campaign such that a waiver of the obligation to provide copies of their applications for tax exemption and their annual information returns is in the public interest. The average time required to complete, assemble and file an application describing a harassment campaign is expected to be 5 hours. Because applications for a harassment campaign determination will be filed so infrequently, they will have no effect on the average time needed to comply with the requirements in these regulations. In addition, a private foundation is allowed in these regulations to charge a reasonable fee for providing copies to requesters. Therefore, it is estimated that it will cost a private foundation less than \$10 per year to comply with these regulations, which is not a significant economic impact.

Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### *Comments and Requests for a Public Hearing*

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) and electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by a person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

#### *Drafting Information*

The principal author of these regulations is Michael B. Blumenfeld, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS. Other personnel from the IRS and Treasury Department also participated in their development.

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#### *Proposed Amendments to the Regulations*

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

#### **PART 301-PROCEDURE AND ADMINISTRATION**

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 301.6104(d)-2 also issued under 26 U.S.C. 6104(d)(3);

Section 301.6104(d)-3 also issued under 26 U.S.C. 6104(d)(3); \* \* \*

#### **§301.6104(d)-1 [Removed]**

Par. 2. Section 301.6104(d)-1 is removed.

#### **§301.6104(d)-2 [Redesignated as §301.6104(d)-0]**

Par. 3. Section 301.6104(d)-2 is redesignated as §301.6104(d)-0.

Par. 4. Newly designated §301.6104(d)–0 is revised to read as follows:

*§301.6104(d)–0 Table of contents.*

This section lists the major captions contained in §§301.6104(d)–1 through 301.6104(d)–3 as follows:

*§301.6104(d)–1 Public inspection and distribution of applications for tax exemption and annual information returns of tax-exempt organizations.*

- (a) In general.
- (b) Definitions.
  - (1) Tax-exempt organization.
  - (2) Private foundation.
  - (3) Application for tax exemption.
    - (i) In general.
    - (ii) No prescribed application form.
    - (iii) Exceptions.
  - (iv) Local or subordinate organizations.
  - (4) Annual information return.
    - (i) In general.
    - (ii) Exceptions.
    - (iii) Returns more than 3 years old.
  - (iv) Local or subordinate organizations.
  - (5) Regional or district offices.
    - (i) In general.
    - (ii) Site not considered a regional or district office.
- (c) Special rules relating to public inspection.
  - (1) Permissible conditions on public inspection.
  - (2) Organizations that do not maintain permanent offices.
  - (d) Special rules relating to copies.
    - (1) Time and place for providing copies in response to requests made in person.
      - (i) In general.
      - (ii) Unusual circumstances.
      - (iii) Agents for providing copies.
    - (2) Request for copies in writing.
      - (i) In general.
      - (ii) Time and manner of fulfilling written requests.
  - (A) In general.
  - (B) Request for a copy of parts of document.
  - (C) Agents for providing copies.
  - (3) Fees for copies.
    - (i) In general.
    - (ii) Form of payment.
  - (A) Request made in person.
  - (B) Request made in writing.
  - (iii) Avoidance of unexpected fees.

- (iv) Responding to inquiries of fees charged.
- (e) Documents to be provided by regional and district offices.
- (f) Documents to be provided by local and subordinate organizations.
  - (1) Applications for tax exemption.
  - (2) Annual information returns.
  - (3) Failure to comply.
- (g) Failure to comply with public inspection or copying requirements.
- (h) Effective date.
  - (1) In general.
  - (2) Private foundation annual information returns.

*§301.6104(d)–2 Making applications and returns widely available.*

- (a) In general.
- (b) Widely available.
  - (1) In general.
  - (2) Internet posting.
- (i) In general.
- (ii) Transition rule.
- (iii) Reliability and accuracy.
- (c) Discretion to prescribe other methods for making documents widely available.
- (d) Notice requirement.
- (e) Effective date.

*§301.6104(d)–3 Tax-exempt organization subject to harassment campaign.*

- (a) In general.
- (b) Harassment.
- (c) Special rule for multiple requests from a single individual or address.
- (d) Harassment determination procedure.
- (e) Effect of a harassment determination.
- (f) Examples.
- (g) Effective date.

*§301.6104(d)–3 [Redesignated as §301.6104(d)–1]*

Par. 5. Section 301.6104(d)–3 is redesignated as §301.6104(d)–1.

Par. 6. Newly designated §301.6104(d)–1 is amended as follows:

- 1. Revise the section heading.
  - 1a. Paragraph (a) is amended as follows:
    - a. Remove the language “, other than a private foundation (as defined in para-

graph (b)(2) of this section),” from the first sentence.

b. Remove the language “, other than a private foundation,” from the second sentence.

c. Remove the language “§§301.6104(d)–4 and 301.6104(d)–5” from the fourth sentence and add “§§301.6104(d)–2 and 301.6104(d)–3” in its place.

2. In paragraph (b) introductory text, remove the language “§§301.6104(d)–4 and 301.6104(d)–5” and add “§§301.6104(d)–2 and 301.6104(d)–3” in its place.

3. In paragraph (b)(1), add a sentence at the end of the paragraph.

4. In paragraph (b)(2), add the language “or a nonexempt charitable trust described in section 4947(a)(1) or a nonexempt private foundation subject to the information reporting requirements of section 6033 pursuant to section 6033(d)” at the end of the sentence.

5. In paragraph (b)(3)(iii)(B), remove the word “or” at the end of the paragraph.

6. Redesignate paragraph (b)(3)(iii)(C) as paragraph (b)(3)(iii)(D) and add a new paragraph (b)(3)(iii)(C).

7. In paragraph (b)(4)(i), remove the last two sentences and add three sentences in their place.

8. Paragraph (b)(4)(ii) is amended as follows:

a. Remove the language “, and the return of a private foundation” from the first sentence.

b. Revise the last sentence.

9. Revise paragraph (h).

The revisions and additions read as follows:

*§301.6104(d)–1 Public inspection and distribution of applications for tax exemption and annual information returns of tax-exempt organizations.*

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \* The term tax-exempt organization also includes any nonexempt charitable trust described in section 4947(a)(1) or nonexempt private foundation that is subject to the reporting requirements of section 6033 pursuant to section 6033(d).

\* \* \* \* \*

(3) \* \* \*

(iii) \* \* \*

(C) In the case of a tax-exempt organization other than a private foundation, the name and address of any contributor to the organization; or

\* \* \* \* \*

(4) \* \* \* (i) \* \* \* Returns filed pursuant to section 6033 include Form 990, Return of Organization Exempt From Income Tax, Form 990-PF, Return of Private Foundation, or any other version of Form 990 (such as Forms 990-EZ or 990-BL, except Form 990-T) and Form 1065. Each copy of a return must include all information furnished to the Internal Revenue Service on the return, as well as all schedules, attachments and supporting documents. For example, in the case of a Form 990, the copy must include Schedule A of Form 990 (containing supplementary information on section 501(c)(3) organizations), and those parts of the return that show compensation paid to specific persons (currently, Part V of Form 990 and Parts I and II of Schedule A of Form 990).

(ii) \* \* \* In the case of a tax-exempt organization other than a private foundation, the term *annual information return* does not include the name and address of any contributor to the organization.

\* \* \* \* \*

(h) *Effective date*—(1) *In general*. For a tax-exempt organization, other than a private foundation, this section is applicable June 8, 1999. Except as provided in paragraph (h)(2) of this section, for a private foundation, this section is applicable beginning 60 days after these regulations are published as final regulations in the **Federal Register**.

(2) *Private foundation annual information returns*. This section applies to any private foundation return the due date for which (determined with regard to any extension of time for filing) is after the applicable date for private foundations specified in paragraph (h)(1) of this section.

#### **§301.6104(d)-4 [Redesignated as §301.6104(d)-2]**

Par. 7. Section 301.6104(d)-4 is redesignated as §301.6104(d)-2.

Par. 8. Newly designated §301.6104(d)-2 is amended as follows:

1. In paragraph (a), remove the language “§301.6104(d)-3(a)” from each place it appears and add “§301.6104(d)-1(a)” in each place, respectively.

2. Revise paragraph (e).

The revision reads as follows:

*§301.6104(d)-2 Making applications and returns widely available.*

\* \* \* \* \*

(e) *Effective date*. For a tax-exempt organization, other than a private foundation, this section is applicable June 8, 1999. For a private foundation, this section is applicable beginning 60 days after these regulations are published as final regulations in the **Federal Register**.

#### **§301.6104(d)-5 [Redesignated as §301.6104(d)-3]**

Par. 9. Section 301.6104(d)-5 is redesignated as §301.6104(d)-3.

Par. 10. Newly designated §301.6104(d)-3 is amended as follows:

1. In paragraph (a), remove the language “§301.6104(d)-3(a)” and add “§301.6104(d)-1(a)” in its place.

2. Revise paragraph (g).

The revision reads as follows:

*§301.6104(d)-3 Tax-exempt organization subject to harassment campaign.*

\* \* \* \* \*

(g) *Effective date*. For a tax-exempt organization, other than a private foundation, this section is applicable June 8, 1999. For a private foundation, this section is applicable beginning 60 days after these regulations are published as final regulations in the **Federal Register**.

Robert E. Wenzel,  
*Deputy Commissioner of  
Internal Revenue.*

(Filed by the Office of the Federal Register on August 9, 1999, 8:45 a.m., and published in the issue of the Federal Register for August 10, 1999, 64 F.R. 43324)

## **Foundations Status of Certain Organizations**

### **Announcement 99-88**

The following organizations have failed to establish or have been unable to

maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

*Former Public Charities*. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

African-American Youth Baseball Association, Desoto, TX  
American Friends of Kollel Beth Hatalmud of Melbourne Australia, Brooklyn, NY  
Arbor Hills Parent Organization, Sylvania, OH  
Arizona Flairs Boosters Inc., Mesa, AZ  
Armenian International Sports Foundation, Woodside, NY  
Arts Pack Inc., Racine, WI  
Association of Rape and Assault Prevention Inc., Silver Spring, MD  
Bone Marrow Lifeline Inc., Greensboro, NC  
Broadhead Mannor Resident Council, Pittsburgh, PA  
Center for Cultural Education Inc., Acton, MA  
CHHS Debate Team Booster Club, Troy, AL  
Childrens Museum of Dayton Inc., Dayton, OH  
Childrens Safety Bureau Inc., San Antonio, TX  
Christian Youth Network of Utah, Sandy, UT  
Coalition for Positive Change, Huntington, WV  
Colorado Gymnastics Parents, Longmont, CO  
Columbus Roadrunners, Columbus, OH  
Concerned Citizens Enterprises Inc., Middletown, OH  
Deaf Childrens Association of America, Saddle Brook, NJ  
Doo Rae Foundation Inc., Flushing, NY  
Each One Teach One, Clarksdale, AZ  
East Marietta Basketball Inc., Marietta, GA



Empowering Parents for Troubled Times Inc., Greensboro, GA  
 Epiphany Enterprises Inc., Jacksonville, FL  
 Family Community Development Corporation, Pine Bluff, AR  
 Filipino-American Law Enforcement Association of Illinois Inc., Chicago, IL  
 Fort Bragg Swim Club, Ft. Bragg, NC  
 Four Season Choral Society Inc., Richardson, TX  
 Franciscan Servants of Divine Mercy Inc., Jackson, MI  
 Gaden Jangtse Monastery, Anaheim, CA  
 Geoff Carroll Memorial Fund, Boston, MA  
 George Foster Foundation Inc., Greenwich, CT  
 Greencastle Antrim Primary School PTO, Greencastle, PA  
 Hidden Talent Theater Inc. C/O Bobbie Flowers, Shreveport, LA  
 Hispanic Mathematical Association of Minnesota Inc., St. Paul, MN  
 International Center for the Deaf, New York, NY  
 Jackson Art Association, Jackson, TN  
 Judy Aaron Ministries, Phoenix, AZ  
 Kangaroo Pouch Day Care & Learning Center, Jayess, MS  
 Kids N Christmas of Arizona, Tempe, AZ  
 Kiwanis Horses for Handicapped Foundation of Pinellas County Inc., Seminole, FL  
 Largo-Tibet Parent Teacher Organization, Savannah, GA  
 Licking County Crime Stoppers Inc., Newark, OH  
 Lighthouse Institute for Public Policy Inc., Cochituate, MA  
 Lineville Band Boosters Inc., Lineville, AL  
 Living Hope International, Clackamas, OR  
 Lone Star Youth Council Inc., Jasper, TX  
 Magnolia Opera Festival Inc., Carrboro, NC  
 Marshall County Educational Resource Center Inc., Benton, KY  
 Marshall Education Trust Fund, Marshall, IL  
 Mid-City Community Development Corporation, New Orleans, LA  
 Multi-Media Resource Center, Lansing, MI  
 Multicultural Alliance of Ponca City Incorporated, Ponca City, OK

Multicultural Committee of Ocean County Inc., Toms River, NJ  
 Needy People Foundation Inc., Brooklyn, NY  
 New Life Academy Inc., Macon, GA  
 New York Coastal Partnership Inc., Babylon, NY  
 Oaks Youth Project Inc., Tahlequah, OK  
 Onward Paterson Through the 90s Inc., Paterson, NJ  
 Organization for the Betterment of Youth, Las Vegas, NV  
 Peninsula Little League, San Diego, CA  
 Polliwog Place Child Development Center, Metropolis, IL  
 Poultney Project Care, Poultney, VT  
 Preschool Services Inc., Scottsdale, AZ  
 Progressive Youth Services Inc., Houston, TX  
 Romanian Childrens Aid Inc., Dallas, TX  
 Ryan Scherbel Foundation, Willis, TX  
 Safekeeping, Denmark, ME  
 Sandwich Home Nursing and Health Association, Center Sandwich, NH  
 Sharks Foundation, San Jose, CA  
 Sheridan All Seasons Center Association, Sheridan, WY  
 Sibley County Coral Society Inc., Arlington, MN  
 Silent Servants, Redford, MI  
 South Carolina Traditional Jazz Foundation, Gadsden, SC  
 Southwest Juniors Volleyball Association Inc., Tempe, AZ  
 Spark, Nashville, TN  
 Sportsfest Inc., Bronxville, NY  
 Tabernacle of Praise Ministries, Sacramento, CA  
 Texas Association for Spiritual Knowledge, Dallas, TX  
 Texas Celebration 150 Inc., Irving, TX  
 The American Aesthetic Institute, Minneapolis, MN  
 The Juniper Foundation Inc., Albany, NY  
 The Starfire Booster Club Inc., Carrollton, TX  
 Time-Out for Youth Inc., Rutherfordton, NC  
 Unified and Involved Community Action Network U & I Can, Bryan, TX  
 Union Park-N-Play Committee, Union, ME  
 Voices of Kentuckiana Inc., Louisville, KY  
 Volunteer Action Center of Greater Lorain County, Elyria, OH  
 W O C T Inc., Arlington, TX  
 West Side Cares Inc., New York, NY

Whaz-Up Productions Inc., Lithonia, GA  
 Williams Community Center Association, Williams, CA  
 Women of Color Inc., Chicago, IL

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)-7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

## Section 195—Start-up Expenditures

### Announcement 99-89

This announcement reflects corrections of typographical errors and omissions in Rev. Rul. 99-23, 1999-20 I.R.B. 3, dated May 17, 1999.

In the LAW AND ANALYSIS section of Rev. Rul. 99-23 (ninth paragraph), the quoted language from the legislative history of § 195 of the Internal Revenue Code is corrected to read as follows:

... [E]ligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc. . . .

Startup expenditures eligible for amortization do not include any amount with respect to which a deduction would not be allowable to an existing trade or business for the taxable year in which the expenditure was paid or incurred.... In addition, the amortization election for startup expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, startup expenditures do not include amounts paid or incurred for the acquisition of property to be held for sale or property which may be de-

preciated or amortized based on its useful life. . . . Whether an amount is consideration paid to acquire a business . . . depends upon the facts and circumstances of the situation.

In the last sentence of the LAW AND ANALYSIS section, “T’s” is corrected to read “Z’s” before the words “internal documents.”

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### **Form 10318, Deduction for Depletion on Ground Water Used for Irrigation; Obsolete**

#### **Announcement 99-90**

**Form 10318**, Deduction for Depletion on Ground Water Used for Irrigation, is

obsolete. It was previously used by taxpayers who extracted ground water from the Ogallala geological formation for irrigation. Taxpayers claiming this depletion should continue to deduct it on the depletion line of their tax returns. No attachment is necessary. See Rev. Proc. 66-11, 1966-1 C.B. 624 and Rev. Rul. 82-214, 1982-2 C.B. 115.

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### **Reporting of Earnings on Excess Contributions to Medical Savings Accounts (MSAs)**

#### **Announcement 99-93**

The 1998 Instructions for Form 8853, Medical Savings Accounts and Long-

Term Care Insurance Contracts, and Form 5329, Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs, contain an error. The instructions for Form 8853, line 7, and Form 5329, Part VI, state that the income earned on certain excess contributions withdrawn from an MSA must be included in gross income for the year in which the MSA participant or the employer made the contribution. Instead, the earnings must be included in gross income for the year in which the earnings and the excess contributions are withdrawn.

## Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it ap-

plies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

## Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C.—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.

E.O.—Executive Order.  
ER—Employer.  
ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contribution Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
F.R.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign Corporation.  
G.C.M.—Chief Counsel's Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.

PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.  
PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statements of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.



## Numerical Finding List<sup>1</sup>

Bulletins 1999–27 through 1999–35

### Announcements:

99–47, 1999–28 I.R.B. 29  
99–64, 1999–27 I.R.B. 7  
99–65, 1999–27 I.R.B. 9  
99–66, 1999–27 I.R.B. 9  
99–67, 1999–28 I.R.B. 31  
99–68, 1999–28 I.R.B. 31  
99–69, 1999–28 I.R.B. 33  
99–70, 1999–29 I.R.B. 118  
99–71, 1999–31 I.R.B. 223  
99–72, 1999–30 I.R.B. 132  
99–73, 1999–30 I.R.B. 133  
99–74, 1999–30 I.R.B. 133  
99–75, 1999–30 I.R.B. 133  
99–76, 1999–31 I.R.B. 223  
99–77, 1999–32 I.R.B. 243  
99–78, 1999–31 I.R.B. 229  
99–79, 1999–31 I.R.B. 229  
99–80, 1999–34 I.R.B. 310  
99–81, 1999–32 I.R.B. 244  
99–82, 1999–32 I.R.B. 244  
99–83, 1999–32 I.R.B. 245  
99–84, 1999–33 I.R.B. 248  
99–85, 1999–33 I.R.B. 248  
99–86, 1999–35 I.R.B. 332  
99–87, 1999–35 I.R.B. 333

### Notices:

99–34, 1999–35 I.R.B. 323  
99–35, 1999–28 I.R.B. 26  
99–37, 1999–30 I.R.B. 124  
99–38, 1999–31 I.R.B. 138  
99–39, 1999–34 I.R.B. 313  
99–40, 1999–35 I.R.B. 324  
99–41, 1999–35 I.R.B. 325  
99–42, 1999–35 I.R.B. 325  
99–44, 1999–35 I.R.B. 326

### Proposed Regulations:

REG–252487–96, 1999–34 I.R.B. 303  
REG–101519–97, 1999–29 I.R.B. 114  
REG–106527–98, 1999–34 I.R.B. 304  
REG–108287–98, 1999–28 I.R.B. 27  
REG–113909–98, 1999–30 I.R.B. 125  
REG–116991–98, 1999–32 I.R.B. 242  
REG–105237–99, 1999–35 I.R.B. 331  
REG–105327–99, 1999–29 I.R.B. 117

### Revenue Procedures:

99–28, 1999–29 I.R.B. 109  
99–29, 1999–31 I.R.B. 138  
99–30, 1999–31 I.R.B. 221  
99–31, 1999–34 I.R.B. 280  
99–32, 1999–34 I.R.B. 296  
99–33, 1999–34 I.R.B. 301

### Revenue Rulings:

99–29, 1999–27 I.R.B. 3  
99–30, 1999–28 I.R.B. 24  
99–32, 1999–31 I.R.B. 135  
99–33, 1999–34 I.R.B. 251  
99–34, 1999–33 I.R.B. 247  
99–35, 1999–34 I.R.B. 278  
99–36, 1999–35 I.R.B. 319

### Treasury Decisions:

8822, 1999–27 I.R.B. 5  
8823, 1999–29 I.R.B. 34  
8824, 1999–29 I.R.B. 62  
8825, 1999–28 I.R.B. 19  
8826, 1999–29 I.R.B. 107  
8827, 1999–30 I.R.B. 120  
8828, 1999–30 I.R.B. 120  
8829, 1999–32 I.R.B. 235  
8831, 1999–34 I.R.B. 264  
8832, 1999–35 I.R.B. 315  
8834, 1999–34 I.R.B. 251  
8835, 1999–35 I.R.B. 317

<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 1999–1 through 1999–26 will be found in Internal Revenue Bulletin 1999–27, dated July 6, 1999.

## Finding List of Current Action on Previously Published Items<sup>1</sup>

Bulletins 1999–27 through 1999–35

### Announcements:

#### 99–59

Corrected by  
Ann. 99–67, 1999–28 I.R.B. 31

### Notices:

#### 96–64

Modified by  
Notice 99–40, 1999–35 I.R.B. 324

#### 97–26

Modified by  
Notice 99–41, 1999–35 I.R.B. 325

#### 97–73

Modified by  
Notice 99–37, 1999–30 I.R.B. 124

#### 98–7

Modified by  
Notice 99–37, 1999–30 I.R.B. 124

#### 98–46

Modified by  
Notice 99–37, 1999–30 I.R.B. 124

#### 98–54

Modified by  
Notice 99–37, 1999–30 I.R.B. 124

#### 98–59

Modified by  
Notice 99–37, 1999–30 I.R.B. 124

### Proposed Regulations:

#### REG–208156–91

Corrected by  
Ann. 99–65, 1999–27 I.R.B. 9

### Revenue Procedures:

#### 65–17

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

#### 65–31

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

#### 70–23

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

#### 71–35

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

#### 72–22

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

#### 72–46

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

#### 72–48

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

#### 72–53

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

### Revenue Procedures—Continued

#### 96–9

Superseded by  
Rev. Proc. 99–28, 1999–29 I.R.B. 109

#### 97–19

Modified by  
Notice 99–41, 1999–35 I.R.B. 325

#### 98–22

Corrected by  
Rev. Proc. 99–31, 1999–34 I.R.B. 280

#### 98–35

Superseded by  
Rev. Proc. 99–29, 1999–31 I.R.B. 138

### Revenue Rulings:

#### 82–80

Superseded by  
Rev. Proc. 99–32, 1999–34 I.R.B. 296

### Treasury Decisions:

#### 8476

Corrected by  
Ann. 99–74, 1999–30 I.R.B. 133

#### 8742

Corrected by  
Ann. 99–73, 1999–30 I.R.B. 133

#### 8793

Corrected by  
Ann. 99–75, 1999–30 I.R.B. 134

#### 8805

Corrected by  
Ann. 99–66, 1999–27 I.R.B. 9

#### 8819

Corrected by  
Ann. 99–47, 1999–28 I.R.B. 29

<sup>1</sup> A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1999–1 through 1999–26 will be found in Internal Revenue Bulletin 1999–27, dated July 6, 1999.

## Index

### Internal Revenue Bulletins 1999–27 Through 1999–35

For the index of items published during 1998, see I.R.B. 1999–1, dated January 4, 1999.

The abbreviation and number in parenthesis following the index entry refer to the specific item; numbers in roman and italic type following the parenthesis refer to the Internal Revenue Bulletin in which the item may be found and the page number on which it appears.

#### Key to Abbreviations:

Ann	Announcement
RR	Revenue Ruling
RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

## EMPLOYEE PLANS

#### Funding:

Full funding limitations, weighted average interest rate for July 1999 (Notice 38) 31, 138; August 1999 (Notice 39) 34, 313

Limitations on contributions and benefits under section 415 (Notice 44) 35, 326

#### Qualifications:

Administrative programs; acceptable correction methods and examples under the Employee Plans Compliance Resolution System (EPCRS) (RP 31) 34, 280

Governmental plans; nondiscrimination rules (Notice 40) 35, 324

#### Regulations:

26 CFR 1.411(d)–4, amended; 1.411(d)–4T, removed; employee stock ownership plans, qualified retirement plan benefits (T.D. 8806) 6, 4; correction (Ann. 84) 33, 248

## EMPLOYMENT TAX

#### Electronic filing; magnetic media:

Form 1042-S, specifications for filing (Ann. 79) 31, 229

Forms 1098, 1099, 5498, W-2G; specifications – Pub. 1220 (RP 29) 31, 138

Information reporting seminars for 1999 (Ann. 59) 24, 52; correction (Ann. 67) 28, 31

#### Federal tax deposits:

Elimination of magnetic tape (Notice 42) 35, 325

#### Regulations:

26 CFR 1.1502–15T, –21T, –22T, –23T, removed; 1.1502–1, amended; 1.1502–15, –21, –22, –23, added; consolidated returns–limitations on the use of certain losses and deductions (T.D. 8823) 29, 34; correction (Ann. 86) 35, 332

31.6302–1, amended; electronic funds transfers of federal deposits (T.D. 8828) 30, 120

26 CFR 31.6302–1(f)(4), revised; 31.6302–1T, removed; federal employment tax deposits – *de minimis* rule (T.D. 8822) 27, 5

#### Tax Payments:

Magnetic media (Notice 42) 35, 325

## ESTATE TAX

#### Regulations:

26 CFR 20.2031–0, revised; 20.2031–7, –7A, amended; 20.2031–7T, added; 20.2055–2, amended; 20.7520–1, amended; 20.7520–1T, added; valuation of annuities, interests for life or term of years, and remainder or reversionary interests (T.D. 8819) 20, 5; correction (Ann. 47) 28, 29

26 CFR 20.6302–1, added; electronic funds transfers of federal deposits (T.D. 8828) 30, 120

## EXCISE TAX

#### Regulations:

26 CFR 31.3221–4, added; exception from supplemental annuity tax on railroad employers (T.D. 8832) 35, 315

26 CFR 40.6302(a)–1, added; electronic funds transfers of federal deposits (T.D. 8828) 30, 120

## EXEMPT ORGANIZATIONS

List of organizations classified as private foundations (Ann. 64) 27, 7; (Ann. 68) 28, 31; (Ann. 70) 29, 118; (Ann. 78) 31, 229; (Ann. 83) 32, 242; (Ann. 85) 33, 248; (Ann. 80) 34, 310; (Ann. 87) 35, 333

#### Regulations:

26 CFR 301.6104(d)–2 through –5, added; public disclosure of material relating to tax-exempt organizations (T.D. 8818) 17, 3

Revocations (Ann. 72) 30, 132

## GIFT TAX

#### Proposed regulations:

26 CFR 25.2702–3, amended; definition of a qualified interest in a grantor retained annuity trust and a grantor retained unitrust (REG–108287–98) 28, 27

#### Regulations:

26 CFR 25.2512–0, revised; 25.2512–5, –5A, amended; 25.2512–5T, added; 25.7520–1, –3, amended; 25.7520–1T, added; valuation of annuities, interests for life or term of years, and remainder or reversionary interests (T.D. 8819) 20, 5; correction (Ann. 47) 28, 29

26 CFR 25.6302–1, added; electronic funds transfers of federal deposits (T.D. 8828) 30, 120

## INCOME TAX

#### Action on Decision:

Boyd Gaming Corp. v. Commissioner (Ann. 77) 32, 234, 243

#### Allocation of income and deductions:

Adjustment of accounts (RP 32) 34, 296

#### Credits:

Qualified student loan interest; information reporting (Notice 37) 30, 124

Depreciation and amortization, Form 4562, correction to recovery period for personal property (Ann. 82) 32, 244

#### Depreciation–section 168:

Treasury depreciation study; request for public comment (Notice 34) 35, 323



## INCOME TAX—Continued

Early referral of issues to appeals (RP 28) 29, 109

Electronic filing; magnetic media:  
Forms 1098, 1099, 5498, W-2G; specifications – Pub. 1220 (RP 29) 31, 138

Estimated tax payments:  
Elimination of magnetic tape (Notice 42) 35, 325

Foreign contingent debt (Ann 76) 31, 223

Forms:  
1042-S, specifications for filing magnetically/electronically (Ann. 79) 31, 229  
4562, correction to recovery period for personal property (Ann. 82) 33, 244

Standard Industry Fare Level (SIFL) rates for the second half of 1999 (RR 33) 34, 251

Interest:  
Investment:  
Federal short-term, mid-term, and long-term rates for July 1999 (RR 29) 27, 3; August 1999 (RR 32) 31, 135

Rates:  
Underpayments and overpayments for calendar quarter beginning October 1, 1999 (RR 36) 35, 319

Insurance companies:  
Differential earnings rate and recomputed differential earnings rate for mutual life insurance companies (RR 35) 34, 278

Inventory:  
LIFO:  
Price indexes; department stores for May 1999 (RR 30) 28, 24; June 1999 (RR 34) 33, 247

Litigation guideline memoranda (1/1/86-10/20/98), available for public inspection (Ann. 81) 32, 244

Low-income housing tax credit:  
Unused housing credit carryovers under section 42(h)(3)(D) for 1999 (RP 33) 34, 301

Minimum effectively connected net investment income (RP 30) 31, 221

Original issue discount (OID) tables are no longer available electronically from the IRS bulletin board (Ann. 71) 31, 223

Page numbers change in Internal Revenue Bulletins (Ann. 69) 28, 33

Private foundations, organizations classified as (Ann. 78) 31, 229; (Ann. 83) 32, 242; (Ann. 85) 33, 248; (Ann. 80) 34, 310; (Ann. 87) 35, 333

## INCOME TAX—Continued

Proposed regulations:  
26 CFR 1.1(h)–1, added; 1.1223–3, added; 1.741–1, amended; capital gains, partnership, subchapter S, and trust provisions (REG–106527–98) 34, 304

26 CFR 1.446–1, amended; 1.451–3, removed; 1.451–5, amended; 1.460–0, amended; 1.460–1 through 1.460–3, revised; 1.460–4, amended; 1.460–5, revised; 1.460–6, amended; 1.460–7 and 1.460–8, removed; accounting for long-term contracts (REG–208156–91) 22, 11; correction (Ann. 65) 27, 9

26 CFR 1.460–4, removed; 1.460–1, –2, –3, –4, –5, added; 1.446–1, amended; 1.451–3, removed; 1.451–5, amended; 1.460–0, amended; 1.460–1 through 1.460–3, revised; 1.460–4, amended; 1.460–5, revised; 1.460–6, amended; 1.460–7, –8, removed; accounting for long-term contracts (REG–208156–91) 22, 11; correction (Ann. 65) 27, 9

26 CFR 1.671–2(e), revised; inbound grantor trusts with foreign grantors (REG–252487–96) 34, 303

26 CFR 1.904–5(k)(1), revised; 1.954–0, –1, amended; 1.954–2(a)(5) and (a)(6), added; 1.954–9, added; under subpart F: withdrawal of guidance relating to partnerships and branches; new guidance relating to certain hybrid transactions (REG–113909–98) 30, 125

26 CFR 1.1397E–1, amended; qualified zone academy bonds; obligations of states and political subdivisions (REG–105327–99) 29, 117

26 CFR 1.6109–2, paragraph (a), revised and paragraph (d), added; alternative identifying numbers for income tax return preparers (REG–105237–99) 35, 331

26 CFR 301.6323(j)–1, added; withdrawal of notice of federal tax lien in certain circumstances (REG–101519–97) 29, 114

26 CFR 301.7122–1, added; compromise of tax liabilities (REG–116991–98) 32, 242

Qualified zone academy bond credit rate (Notice 35) 28, 26

## INCOME TAX—Continued

Regulations:  
26 CFR 1.148–11, amended; arbitrage restrictions on tax-exempt bonds (T.D. 8476, 1993–2 C.B. 13); correction (Ann. 74) 30, 133

26 CFR 1.170A–6, amended; 1.170A–12T, added; 1.642(c)–6, amended; 1.642(c)–6T, added; 1.642(c)–6A, amended; 1.664–4, –4A, amended; 1.7520–1, amended; 1.7520–1T, added; valuation of annuities, interests for life or terms of years, and remainder or reversionary interests (T.D. 8819) 20, 5; correction (Ann. 47) 28, 29

26 CFR 1.367(e)–0T, –1T, –2T, removed; 1.367(e)–0, –1, –2, added; 1.6038B–1, –1T, amended; treatment of distribution to foreign persons under sections 367(e)(1) and (2) (T.D. 8834) 34, 251

26 CFR 1.382–5T redesignated as 1.382–5, amended; 1.382–8T redesignated as 1.382–8, amended; 1.382–1, –2, –2T, –4, amended; application of section 382 in short taxable years and with respect to controlled groups (T.D. 8825) 28, 19

26 CFR 1.643(h)–1, added; 1.671–2(e), revised; 1.671–2T, added; 1.672(f)–1 through –5, added; inbound grantor trusts with foreign grantors (T.D. 8831) 34, 264

26 CFR 1.861–8, amended; 1.861–8T, amended; 1.865–1T, added; 1.865–2, added; 1.865–2T, added; 1.904–0, amended; 1.904–4, amended; allocation of loss with respect to stocks and other personal property (T.D. 8805) 5, 14; correction (Ann. 66) 27, 9

26 CFR 1.904–5, amended; 1.904–5T, removed; 1.954–1, amended; 1.954–1T, –2T, removed; 1.954–9T, removed; 301.7701–3, amended; 301.7701–3T, removed; removal of regulations providing guidance under subpart F relating to partnerships and branches (T.D. 8827) 30, 120

26 CFR 1.1397E–1T, amended; qualified zone academy bonds; obligations of states and political subdivisions (T.D. 8826) 29, 107

26 CFR 1.1502–15T, –21T, –22T, –23T, removed; 1.1502–1, amended; 1.1502–15, –21, –22, –23, added; consolidated returns–limitations on

## INCOME TAX—Continued

the use of certain losses and deductions (T.D. 8823) 29, 34

26 CFR 1.1502-90T redesignated as 1.1502-90A; 1.1502-91T through -99T, removed; 1.1502-90 through -99, added; 1.1502-91A through -99A, added; 1.1502-20, amended; limitations on net operating loss carryforwards and certain built-in losses and credits following an ownership change of a consolidated group (T.D. 8824) 29, 62

26 CFR 1.6109-2, paragraph (a), revised and paragraph (d), added;

## INCOME TAX—Continued

1.6109-2T, added; alternative identifying numbers for income tax return preparers (T.D. 8835) 35, 317

26 CFR 1.6302-4, revised; electronic funds transfers of federal deposits (T.D. 8828) 30, 120

26 CFR 301.6311-2T, amended; payment by credit card and debit card; (T.D. 8793) 7, 15; correction (Ann. 75) 30, 134

26 CFR 301.7122-1, removed; 301.7122-0T and -1T, added; compromise of tax liabilities (temporary) (T.D. 8829) 32, 235

## INCOME TAX—Continued

26 CFR 602.101, amended; requirements respecting the adoption or change of accounting method; extension of time to make elections; (T.D. 8742, 1998-5 I.R.B. 4); correction (Ann. 73) 30, 133

Residential rental property, correction to recovery period for personal property in Pub. 527 (Ann. 82) 32, 244

Private delivery services; timely filing or payment (Notice 41) 35, 325

## Notes



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